STAFF PAPER

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Project	**Leases**		
Paper topic	In-Substance Fixed Payments		
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Objective

1. The purpose of this paper is to provide the Boards with information and analysis about variable lease payments that are in-substance fixed payments. Agenda Paper 3B/FASB Memo 278 discusses the accounting for initial and subsequent measurement of variable lease payments. Paper 3B/FASB Memo 278 also asks the Boards to reaffirm their decision to exclude variable lease payments (other than those that depend on an index or a rate) from the definition of *lease payments*. Accordingly, variable lease payments that are not in-substance fixed payments are excluded from the discussion in this paper.

2. This paper is structured as follows:

    (a) Summary of Staff Recommendations

    (b) Background

    (c) Summary of the Proposals in the 2013 ED

    (d) Summary of Feedback Received on the 2013 ED

    (e) Staff Analysis

(f) Staff Recommendation

(g) Appendix A–The Proposals in the 2013 ED.

Summary of Staff Recommendations

3. In summary, the staff recommend that the final leases standard:

   (a) Retain the principle that variable lease payments that are in-substance fixed payments should be included in the definition of *lease payments*;

   (b) Note in the Basis for Conclusions that the notion of variable lease payments that are in-substance fixed payments exists under current practice; and

   (c) Include additional illustrative examples of the nature provided in this paper to help clarify the types of variable lease payments that the Boards would and would not view as in-substance fixed payments.

Background

4. Topic 840, *Leases* and IAS 17 *Leases* currently do not include guidance on when, if ever, variable lease payments that are in-substance fixed payments should be included within the definition of *minimum lease payments*. However, on the basis of feedback received from constituents, as well as the review of existing interpretive guidance from the major accounting firms, the concept of including "in-substance fixed payments" in *minimum lease payments* is well established in current practice. Additionally, the staff note that the concept of capturing items that are in-substance fixed because they are readily determinable exists elsewhere in existing guidance (for example, with respect to determining whether a notional amount exists in U.S. GAAP derivatives accounting under ASC Topic 815, *Derivatives and Hedging*).

5. The majority of those that participated in outreach with respect to the 2013 ED (which included preparers, users, accounting firms, and others) supported

including variable lease payments that are in-substance fixed payments in the definition of *lease payments*. Accounting firms and regulators noted the importance of defining and providing examples of in-substance fixed payments to ensure consistent application and comparability between entities.

Summary of the Proposals in the 2013 ED

6. The 2013 ED proposed to include variable lease payments that are in-substance fixed payments in the definition of *lease payments*. What is or is not included in the definition of *lease payments* affects the measurement of (a) the lessee's lease liability and right-of-use (ROU) asset, (b) the measurement of the lessor's lease receivable, and (c) lease classification. The Boards' rationale for this decision, as expressed in the Basis for Conclusions to the 2013 ED, was that those payments are unavoidable and, thus, economically indistinguishable from fixed lease payments.

7. After concluding that only variable lease payments that depend on an index or a rate should be included in the initial measurement of lease assets and lease liabilities, the Boards decided to introduce the concept of in-substance fixed payments that exists in current practice in the 2013 ED. They did so to mitigate potential structuring opportunities that could arise from changing the terms in a contract to what might appear to be variable payments when those payments are, in effect, fixed payments. There would be an incentive to do so if most variable lease payments are excluded from the measurement of lease assets and lease liabilities. Refer to Agenda Paper 3B/FASB Memo 278 for further discussion of variable lease payments.

8. In reaching that decision, the Boards considered the extent to which the requirements should include detailed guidance on variable lease payments that are in-substance fixed payments. The Boards concluded that providing a principle would be sufficient rather than a list of possible scenarios that could not capture

every situation and could result in some operational challenges from an implementation standpoint.

9. To help with the application of the principle to include variable lease payments that are in-substance fixed payments, the Boards decided to include in the 2013 ED some illustrative examples of the types of variable lease payments that would be considered to be in-substance fixed payments. The proposals and examples from the 2013 ED are included in Appendix A of this paper.

10. The Boards considered, but ultimately rejected, including variable lease payments that meet a high recognition threshold (such as reasonably assured or reasonably certain) in the definition of *lease payments*. The Boards rejected this proposal mainly for cost-benefit reasons, but also because some Board members do not think that variable lease payments linked to future performance or use meet the definition of an asset (for the lessor) or a liability (for a lessee) until the performance or use occurs.

Summary of Feedback Received on the 2013 ED

11. Limited feedback was received on the notion of in-substance fixed payments. However, of those that commented, most supported including variable lease payments that are in-substance fixed payments in the definition of *lease payments*. These constituents said that it is appropriate to include such payments in the measurement of lease assets and lease liabilities because they are unavoidable.

12. Many constituents commented on the difficulty of interpreting the meaning of in-substance fixed payments. These constituents said that the judgment required to interpret what would be considered an in-substance fixed payment could result in inconsistent application. One regulator noted that inconsistent application could lead to issues with enforceability.

13. Almost all constituents that commented thought that the examples provided in the 2013 ED, without other guidance, would not be sufficient to ensure consistent application in practice.

14. Some constituents interpreted the examples in the 2013 ED to be examples of strictly fixed payments, rather than variable lease payments that are *in-substance* fixed payments. These constituents thought that if the Boards intended for the term *in-substance fixed payments* to encompass more than strictly fixed payments, then additional guidance as to whether, and under what circumstances, payments that are contractually variable, but in-substance fixed, should be included in the guidance. In addition, despite the Boards decision to the contrary, some constituents questioned whether variable lease payments based on performance or use that are estimated to be highly probable are intended to be included as in-substance fixed payments.

> We encourage the Boards to provide additional guidance regarding when variable payments would be considered in-substance fixed payments. We note that the examples illustrate contractually unavoidable payments that are identified as variable, but appear to be minimum fixed payments. This leaves unresolved whether variable payments subject to a threshold that has a high probability of being achieved would be considered in-substance fixed payments, similar to how some have interpreted the existing guidance in IAS 17. (CL#621 – *International Regulator*)

15. Some of those that commented also expressed concern over potential structuring opportunities. These constituents thought that lease assets and lease liabilities could be understated by structuring payments as variable lease payments. They were also concerned that the proposals for variable lease payments would allow some payments that are currently treated as minimum lease payments to be

excluded from *lease payments* in the new leases standard, and, therefore, to be excluded from the measurement of lease assets and lease liabilities.

16. These constituents thought that structuring would be less likely to occur if greater clarity was provided around what was meant by "in-substance fixed payments." The following comment from an accounting practitioner explains how most view current practice with regard to in-substance fixed payments:

> We are also concerned that the guidance in the ED regarding in substance fixed payments (paragraph 842-20-55-46 to 55-52) will allow some in substance fixed payments that are treated as minimum lease payments under current accounting to be treated as variable payments under the ED. All of the examples in the ED illustrate situations in which it is a mathematical certainty that a minimum amount of lease payments will be made. In practice under current accounting, we believe most accountants also include as a minimum lease payment contingent rent payments that are not based on the use or performance of the lease asset when it is remote that the lease payment will not be made." (CL #99 – *Accounting Consultancy Firm*)

Staff Analysis

17. The staff think that the Boards should retain the requirement that variable lease payments that are in-substance fixed payments be included in *lease payments*. This is because:

    (a) Those payments are unavoidable and, thus, economically are indistinguishable from fixed lease payments. Accordingly, they should be treated consistently with fixed lease payments and included in the lessee's lease liability and the lessor's lease receivable (for lessor Type A leases);

(b) Excluding these payments from the definition of *lease payments* could result in significantly reduced lease assets and lease liabilities as compared with the assets and liabilities that would be recognized if *lease payments* were to include all of the amounts that are considered *minimum lease payments* in current practice; and

(c) Excluding these payments from the definition of *lease payments* would introduce a significant structuring opportunity for lessees not to recognize lease assets and lease liabilities on the balance sheet. The recognition of assets and liabilities for most leases would create a significantly greater incentive than under existing requirements for entities to reduce the amounts determined to be *lease payments*.

18. If the Boards reaffirm that *lease payments* should include variable lease payments that are in-substance fixed payments, the staff think that the Boards should provide additional guidance on those payments by:

(a) Noting in the Basis for Conclusions that the notion of variable lease payments that are in-substance fixed payments exists under current practice; and

(b) Including additional illustrative examples in the final leases guidance.

19. The staff think that the following examples, or similar examples, would provide additional clarity, improve understandability, and help to ensure consistent application in regards to determining variable lease payments that are in-substance fixed payments. Those examples, in essence, indicate that the staff consider in-substance fixed payments to include:

(a) Those payments that do not create genuine or true variability—for example, those that include clauses that do not appear to have real economic substance, such that the payments are readily determinable (see Examples 1 and 2). In contrast, the staff think that payments that directly vary based on future performance or use of the underlying asset create genuine variability for the lessee and lessor that has economic substance (Example 3).

(b) The lower of the payments to be made when the lessee has a choice as to which set of payments it makes but *must* make at least one set of payments (Example 4).

Example 1: In-Substance Fixed Payment with Escalation Clause

Lessee enters into a 15-year lease of retail space from Lessor. Lease payments are initially CU30,000 per month in arrears. The lease payments increase by 1 percent annually for every 0.1 percent increase in the Consumer Price Index (CPI) from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2 percent per year. The lease payments cannot decrease in any given year from the prior year. The CPI increase has exceeded 1 percent in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2 percent during the term of the lease. The discount rate is the lessee's incremental borrowing rate of 6 percent because the rate the lessor charges the lessee is not available.

Consistent with how this scenario is generally accounted for in current practice, the lessee and the lessor would consider the 2 percent annual adjustment maximum to be an "in-substance fixed payment".

At Lease Commencement	***Without ISF Payments***	***With ISF Payments***	***Percentage Difference***
ROU Asset	3,496,410	3,945,746	13 percent
Lease Liability	3,496,410	3,945,746	13 percent

For additional context, the staff note that if the escalation provision were for annual increases of the lower of 5 percent or 25 times CPI (rather than 2 percent or 10 times CPI), the difference in the ROU asset and the lease liability at lease commencement between including or excluding the in-substance fixed payments would be 37 percent.

Example 2: Disguised In-Substance Fixed Lease Payments

Lessee enters into a 10-year lease of retail space for which the lease payments will be CU1 per year unless sales are more than CU10,000 for that annual period, in which case the annual lease payment is $1,000,000. The discount rate is the lessee's incremental borrowing rate of 6 percent because the rate the lessor charges the lessee is not available.

In this scenario, the CU1,000,000 is an in-substance fixed payment. The lease was written so as to make the lease payments appear to be performance-based; however, it is clear that the lessee's annual payment will be CU1,000,000.

At Lease Commencement	***Without ISF Payments***	***With ISF Payments***	***Percentage Difference***
ROU Asset	0	7,360,087	100 percent
Lease Liability	0	7,360,087	100 percent

Example 3: Variable Lease Payments That Should Not be Treated as In-Substance Fixed Payments

Lessee enters into a 10-year lease of property for which the lease payments will be 5 percent of the lessee’s sales generated from the leased property. The lessee’s annual sales have exceeded CU100,000 since the inception of business operations and are expected to continue to grow for the foreseeable future.

In this scenario, the lessee and the lessor would not include CU5,000 in the determination of lease payments under the principle of variable lease payments that are in-substance fixed. Although the probability of occurrence would appear to be high on the basis of relevant history and experience, the variable lease payments in this case are based exclusively on, and vary directly with, performance. These payments create genuine variability in the payments to be made by the lessee and received by the lessor. Consequently, those payments would not comprise variable lease payments that are in-substance fixed.

Example 4: Optional Payments That Should Be Treated as In-Substance Fixed Payments

Lessee enters into a sale and leaseback transaction for one of its properties. The leaseback is such that the lessee enters into a 20-year lease of the property for which the annual lease payments are CU100,000, and increase annually in line with the movements in CPI. The lease includes a termination option exercisable by the lessee at the end of year 5 but only if the lessee also exercises an option to buy back the leased property at market value at a specified date.

In this scenario, the lessee and the lessor would consider either (a) the lease payments payable during years 5-20 or (b) the estimated exercise price of the purchase option to be in-substance fixed payments. This is because the lessee is required to pay at least the lower of those two amounts.

20. The variable payments in Example 3 are not considered to be in-substance fixed payments on the basis of the Board's previous decision to exclude variable lease payments based on performance or use from the measurement of lease assets and lease liabilities, including those for which there is a high probability of payment. Accordingly, an entity would not include lease payments that vary solely on the basis of future performance or use in the definition of *lease payments*, regardless of the probability of occurrence (except to the extent that there is a guaranteed minimum payment amount such as that in Example 4A to the 2013 ED (see Appendix A)).

21. The staff note that the forthcoming revenue recognition standard will include a similar restriction to that in Example 3 above on variable consideration resulting from usage and sales-based royalties for licenses of intellectual property. Under that guidance, the transaction price would not include such fees, regardless of the probability of occurrence, until the customer's subsequent sales or usage occur.

Staff Recommendation

22. In summary, the staff recommend that the final leases standard:

    (a) Retain the principle that variable lease payments that are in-substance fixed payments should be included in the definition of *lease payments*;

    (b) Note in the Basis for Conclusions that the notion of variable lease payments that are in-substance fixed payments exists under current practice; and

(c) Include additional illustrative examples of the nature provided in this paper to help clarify the types of variable lease payments that should and should not be viewed as in-substance fixed payments.

Question: Variable Lease Payments That Are In-Substance Fixed Payments
Do the Boards agree with the staff recommendations above, namely (a) to retain the principle that variable lease payments that are in-substance fixed payments should be included in the definition of *lease payments*, (b) to note in the Basis for Conclusions that the notion of variable lease payments that are in-substance fixed payments exists under current practice, and (c) to include additional illustrative examples along the lines of those included in this paper in the final leases guidance?

Appendix A–The Proposals in the 2013 ED

A1. The following is the guidance for variable lease payments that are in-substance fixed payments that was proposed in the 2013 ED:

A2. The glossary of the 2013 ED defines lease payments as the following:

Lease Payments

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, consisting of the following: a) Fixed payments, less any lease incentives received or receivable from the lessor

b) Variable lease payments that depend on an index or a rate or are in-substance fixed payments

c) The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option

d) Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

A3. The 2013 ED included the following illustrative examples in the Application Guidance:

Example 4A—Variable Lease Payments That Are In-Substance Fixed Lease Payments

842-20-55-46 A lessee enters into a 5-year lease of property, with annual payments determined as 2 percent of the lessee's sales generated from the leased property. The annual lease payment must be at least CU100,000 in each year of the lease.

842-20-55-47 At the commencement date, the lessee measures the lease liability on the basis of annual fixed payments of CU100,000. The lessee is required to make payments of at least CU100,000 in each year, regardless of the level of sales from the property. Accordingly, those payments are in-substance fixed lease payments.

Example 4B—Variable Lease Payments That Are In-Substance Fixed Lease Payments

842-20-55-48 A lessee enters into a 5-year lease of property, with an initial annual payment of CU100,000. The contract includes an escalation clause specifying that the lease payment for each year (excluding the first year of the lease) will increase by the higher of the annual increase in the Consumer Price Index for the preceding 12 months, or 2 percent.

842-20-55-49 At the commencement date, the lessee measures the lease liability on the basis of fixed lease payments of CU100,000 in Year 1, CU102,000 in Year 2, CU104,040 in Year 3, CU106,121 in Year 4, and CU108,243 in Year 5. The lessee is required to make payments of at least those amounts in each year during the lease term, regardless of the movement in the Consumer Price Index. Accordingly, those payments are in-substance fixed lease payments.

Example 4C—Variable Lease Payments That Are In-Substance Fixed Lease Payments

842-20-55-50 A lessee enters into a 10-year lease of property, with annual fixed lease payments of CU100,000 and variable lease payments that are determined as 3 percent of the lessee's sales from the property. At the end of the 10-year period, if sales from the property are at least CU1,000,000 in each of the 10 years, the lessee has the option to purchase the property for CU375,000 (at the commencement date, the lessee determines that it does not have a significant economic incentive to exercise the purchase option). However, if sales from the property are less than CU1,000,000 in any of the 10 years of the lease, the lessee is required to purchase the property for CU375,000 at the end of the 10-year period.

842-20-55-51 At the commencement date, the lessee measures the lease liability at the present value of either of the following:

Yearly payments of CU130,000 (the CU100,000 annual fixed payment plus CU30,000 variable payment assuming sales are CU1,000,000)

Fixed annual payments of CU100,000 plus the CU375,000 purchase price payable at the end of Year 10.

842-20-55-52 The exercise price of the purchase option of CU375,000, or the annual payments of CU30,000 for 10 years, are considered to be in-substance fixed payments because the lessee is required to pay at least the lower of those 2 amounts, regardless of the level of sales during the 10-year lease term.