

STAFF PAPER

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Project	Leases		
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Objective

1. The purpose of this paper is to discuss the accounting for options to extend or to terminate a lease, both at lease commencement and during the lease term. This paper also discusses the accounting for purchase options.
2. This paper is structured as follows:
 - (a) Summary of the proposals in the 2013 *Leases* Exposure Draft (“2013 ED”)
 - (b) Summary of feedback
 - (c) Staff analysis and staff recommendations
 - (i) Extension and termination options – initial recognition
 - (ii) Extension and termination options – reassessment
 - (iii) Purchase options
 - (iv) Symmetry between lessee and lessor accounting for options
 - (d) Appendix A – The proposals in the 2013 ED
 - (e) Appendix B – Existing guidance on lease term in IAS 17 and Topic 840

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- (f) Appendix C – Alternatives previously considered and rejected by the boards
3. In this paper, the staff recommend that:
- (a) The threshold for determining the lease term should be a high threshold that is based on whether the lessee is economically compelled to exercise (or not to exercise) an option.
 - (b) “Significant economic incentive” should describe the threshold used to determine the lease term.
 - (c) Some staff recommend that the reassessment requirements for lease term should be removed. Other staff recommend requiring reassessment only upon the occurrence of a significant event or a significant change in circumstances.
 - (d) Purchase options should be accounted for in the same way as options to extend a lease or not to exercise an option to terminate a lease.

Summary of the proposals in the 2013 ED

Extension and termination options

4. The 2013 ED defined the lease term as the noncancellable period for which the lessee has the right to use an underlying asset, together with both of the following:
- (a) Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option.
 - (b) Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.
5. The lease term was used to make different determinations in the 2013 ED:
- (a) ROU asset, lease liability, and lease receivable measurement – The lease payments included in the measurement of the ROU asset, lease liability and lease receivable would be dependent on the lease term. In a Type A lease,

the lease term would also affect the profit relating to the lease recognised by the lessor at lease commencement.

- (b) Lease classification – The lease term affects classification because of the comparison between the lease term and the economic life of the underlying asset when classifying leases. Consequently, the lease term affects how a lessee would recognise and present lease expenses in its income statement.
6. The 2013 ED proposed reassessment of the lease term if either of the following occurs:
- (a) A change in a relevant factor that causes the lessee to either have or no longer have a significant economic incentive to exercise an option or terminate the lease; or
 - (b) The lessee either elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so or does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

However, a change in market-based factors would not, in isolation, trigger reassessment.

7. According to the Basis for Conclusions in the 2013 ED, the significant economic incentive threshold used to determine the lease term would be a threshold that is similar to the concepts of “reasonably assured” and “reasonably certain” in existing U.S. GAAP and IFRS. The 2013 ED proposed that, at lease commencement, an entity would assess whether the lessee has a significant economic incentive to exercise, or not to exercise, an option by considering all factors relevant to that assessment (that is, contract-based, asset-based, market-based and entity-based factors). The 2013 ED provided examples of these factors within the Application Guidance. See Appendix A to this paper for the proposals in the 2013 ED.
8. The 2013 ED did not differentiate between a lessee and a lessor when accounting for options. Both a lessee and a lessor would consider all relevant factors in determining the lease term.

9. The boards have previously considered and rejected various approaches to accounting for options. Appendix C includes a summary of the different approaches that were previously rejected by the boards and the reasons why they were rejected.

Purchase options

10. The 2013 ED proposed that purchase options should be accounted for in the same way as options to extend a lease (that is, the exercise price of a purchase option would be included in the measurement of lease assets and lease liabilities if the lessee has a significant economic incentive to exercise that option).

Summary of feedback

Extension and termination options – initial recognition

11. Many constituents agreed with the boards that options to extend or terminate leases affect the economics of those leases. Many constituents therefore agreed that there is a need to include some renewal options when determining the lease term. This is needed to mitigate the risk of lessees inappropriately excluding lease liabilities from the balance sheet (for example, by excluding lease payments in optional periods for which the lessee has a clear economic incentive to exercise those options).
12. Many of these constituents supported the significant economic incentive threshold proposed in the 2013 ED because it is higher than the “more likely than not” threshold proposed in the 2010 Exposure Draft *Leases* (“2010 ED”). In their view, the higher threshold:
- (a) Generally requires less subjective judgment and estimation.
 - (b) Avoids recognition of amounts that are not present rights and obligations. Some of these constituents added that the substance of the ROU asset and lease liability recognised under the 2013 proposals is more consistent with the boards’ conceptual framework definition of an asset and a liability than the proposals in the 2010 ED.

13. A few of these constituents also supported the significant economic incentive threshold proposed in the 2013 ED because it would simplify the application of existing lease term concepts in current accounting (that is, reasonably certain in IFRS and reasonably assured in U.S. GAAP). These constituents reported that they have seen diversity in practice within and across entities when determining reasonably certain or reasonably assured. This is because:
- (a) Under IFRS, reasonably certain is not defined or described, and
 - (b) IFRS and U.S. GAAP use different terms to determine the lease term.
14. Some of these constituents said that the implementation guidance relating to significant economic incentive provides sufficient guidance for determining the lease term.
15. Others constituents disagreed with the concept of significant economic incentive for various reasons:
- (a) For some constituents, payments to be made during future optional periods do not meet the definition of a liability for the lessee (or a receivable for the lessor) until those options are exercised. That is because, before the exercise date, a lessee can avoid those payments by choosing not to exercise the option. These constituents suggested limiting the lease term to the contractually committed period, that is, the noncancellable period.
 - (b) Other constituents thought the determination of the lease term should be based more on management intent. That is because a lessee might have a significant economic incentive to exercise an option but might have no intention to do so. On the contrary, a lessee might intend to exercise an option without having a significant economic incentive to do so.
 - (c) A few constituents noted that options are distinct from contractually unavoidable payments and should be recognised and measured as separate components of the lease.
16. A majority of constituents expressed concern about the interpretation of the significant economic incentive threshold for the following reasons:

IASB Agenda ref	3G
FASB Agenda ref	274

- (a) In their view, assessing the relevant factors that would give rise to a significant economic incentive is unnecessarily subjective. Consequently, consistent interpretation of the significant economic incentive concept within and across entities may be difficult in practice. Some of these constituents noted that the subjectivity of the proposals could give rise to structuring opportunities.
 - (b) Many constituents highlighted that the 2013 ED does not define the term significant economic incentive and provides limited guidance as to its meaning. Many constituents therefore asked the boards to define significant economic incentive and provide additional guidance regarding how to consider the relevant factors that would give rise to a significant economic incentive. Other constituents asked the boards to clarify what constitutes “significant”.
 - (c) Other constituents interpreted the significant economic incentive threshold to be a high threshold. They, however, were concerned that auditors and regulators might question this assumption because it is not stated explicitly in the Standard. These constituents therefore suggested clarifying in the final Standard that the significant economic incentive threshold is meant to be a high threshold.
17. Many constituents questioned whether the significant economic incentive threshold is the same threshold as in existing guidance. If the boards’ intent is that the significant economic incentive threshold would be applied in a similar way to reasonably certain or reasonably assured, these constituents question why the boards changed the terminology. Some of these constituents thought the boards should retain the terminology in existing IFRS and U.S. GAAP because that terminology would be well-understood in practice and would ensure consistent application amongst entities. On the contrary, if the boards’ intent was that the significant economic incentive threshold would be applied differently compared to existing guidance, the boards should clearly state that in the final Standard and demonstrate how the significant economic incentive threshold differs from existing guidance.

18. Many of these constituents were concerned about the costs and complexity involved with the implementation of any new guidance regarding determining the lease term. Constituents said that new guidance would be particularly costly and complex for entities with decentralised leasing operations, large volumes of leases with unique individual lease term clauses, long maximum possible lease terms or evergreen or month-to-month leases. These constituents noted that a new concept for determining the lease term would incur significant costs and therefore the benefits might not outweigh the costs.
19. Some constituents noted that the 2013 ED requires determination of the lease term from the perspective of the lessee. These constituents were concerned about the ability of a lessor to assess whether the lessee has a significant economic incentive to exercise an option.

Extension and termination options - reassessment

20. Some constituents agreed with the reassessment proposals and stated that the lease term reassessment proposals would not be costly or complex to operationalise. That is because, in their view, a change in relevant factors resulting in the lessee having, or no longer having, a significant economic incentive to exercise an option should be infrequent.
21. However, most constituents expressed concern about the proposal to reassess the lease term. Many of these constituents understood the boards' objective in requiring reassessment of the lease term. They thought, however, that the cost of applying the reassessment proposals would exceed any benefit. They stated that reassessment would be costly for the following reasons:
- (a) The frequency of reassessment – Some constituents were concerned that an entity would have to continuously assess and monitor relevant factors that give rise to a significant economic incentive even though there might not be a change in the lease term. They noted that a lessee often makes a decision regarding the exercise of an option close to the end of the lease term or at the time business strategy changes. Therefore, the lessee might incur

significant costs to continuously reassess the lease term although a change in the lease term might occur only at the end of the initial noncancellable period or when business strategy changes. When an entity determines that remeasurement of the lease assets and lease liabilities is not necessary, these constituents also mentioned that there would be costs involved in demonstrating to their auditors that assumptions regarding a significant economic incentive have not changed.

- (b) The volatility of lease assets and liabilities in a lessee's and lessor's financial statements – Some of these constituents expressed concern that the factors referred to in the 2013 ED (that is, contract-based, asset-based, market-based and entity-based factors) potentially could change multiple times within a given reporting period resulting in continuous remeasurement of a lease liability or a lease receivable. In particular, for a lessor, reassessment of a Type A lease might result in potentially significant changes in reported profits and losses throughout the lease.
 - (c) The administrative challenge to track the data to assess whether the lessee has a significant economic incentive – Because of the subjective nature of the proposed reassessment criteria, some constituents noted that, it might not be possible to apply the proposed reassessment requirements within their IT systems. Rather, they fear that reassessment would have to be computed manually. Also, because lease administration would often be decentralised, the new guidance would require involvement from various departments such as Real Estate, Contract Management, Legal, Treasury, Tax and Internal Audit departments.
 - (d) Applying the reassessment requirements on an individual lease basis.
22. Most constituents questioned the usefulness of the reassessment requirements. This is because reassessment might only result in minor adjustments to (and have little overall effect on) the financial statements, especially on earnings, but would create significant costs.

23. Most constituents who expressed concern about the reassessment proposals provided alternative suggestions. The most common suggestions were the following:
- (a) To remove the requirements to reassess the lease term.
 - (b) To reassess the lease term only when a significant triggering event occurs.
 - (c) To reassess only at each reporting period, for example, only reassess on an annual basis.
 - (d) To reassess at a higher level than an individual lease (that is, to reassess at a portfolio level for leases with similar terms and conditions).
24. Many constituents were concerned about the application of the specific reassessment proposals in the 2013 ED. These constituents noted that the 2013 ED provides limited guidance on reassessment, in particular with regard to what constitutes a change in relevant factors that would cause a lessee to change its assessment of the lease term. Many constituents, therefore, asked the boards to provide more guidance regarding how a change in relevant factors would result in a change to the lease term.
25. A few constituents also questioned why the boards decided to exclude changes in market-based factors from the reassessment of lease term. This would be inconsistent with the requirement to consider market-based factors in the initial assessment of the lease term. These constituents noted that, in the Basis for Conclusions to the 2013 ED, the boards specifically concluded that an entity should take into account all relevant factors in assessing significant economic incentive because many of the factors would be interlinked and it would be both difficult and illogical to require an entity to consider any one factor in isolation. In addition, it would be counterintuitive to ignore market-based factors (such as market rentals for comparable assets), which could create a significant incentive to either extend or terminate a lease.
26. Some constituents suggested different reassessment requirements for lessees and lessors because it might be difficult for a lessor to assess whether lessee-specific factors (such as entity-based factors) have changed.

Purchase options

27. The boards received very little feedback on purchase options. The feedback received was generally consistent with the feedback received on renewal and termination options.

User views

28. Users consulted generally supported the proposed measurement of options. Almost all noted that they would not want subjective estimates about renewal options included in the reported asset and liability amounts. In their view, it would make the balance sheet amounts less reliable and, thus, less useful for their analyses. Accordingly, they said that the higher threshold proposed in the 2013 ED would be preferable to the more likely than not threshold proposed in the 2010 ED. A number of users also thought that it is more appropriate to reflect the economic difference between noncancellable and optional lease periods on a lessee's balance sheet (as proposed in the 2013 ED).
29. However, some users, including those within one credit rating agency, preferred management to include in the measurement of lease assets and lease liabilities an estimate of expected payments in the future, including expected optional payments. In their view, this would give them better information about expected future cash outflows. Despite a preference for recognition on the balance sheet, the credit rating agency analysts noted that sufficient disclosures in the notes about renewal options would be likely to serve their informational needs in this respect.
30. Some users were concerned that the proposed guidance could lead to structuring leases by providing lessees with an incentive to shorten the lease terms. This could result in lessees understating their assets and liabilities or avoiding balance sheet recognition altogether by entering into leases with shorter noncancellable periods, or recurring one-year leases that qualify for the short-term recognition and measurement exemption.
31. The staff received only minor feedback on reassessment from users. Users who commented generally agreed with the reassessment proposals in the 2013 ED. In their view, any changes to the economic substance of a lease should be reflected in the

lease assets and lease liabilities. These users, however, acknowledged that reassessment of the lease term should be rare. A few of these users specifically noted that they agree that a change in market-based factors in isolation should not result in reassessment.

Staff analysis and staff recommendations

Extension and termination options – initial recognition

Which threshold should be used for determining the lease term?

32. This section discusses which threshold to use in the final standard for determining when an entity should include optional periods in the measurement of lease assets and lease liabilities. This section does *not* discuss which specific terminology to use in the final standard for the guidance on lease term. That is discussed in the next section.
33. The lease term threshold proposed in the 2013 ED focussed on the lessee's economic incentive to extend (or not to terminate) a lease. The threshold proposed in the 2013 ED is a high threshold intended to be similar to the concepts of reasonably assured and reasonably certain in existing U.S. GAAP and IFRS. That threshold would mainly capture the noncancellable period and would include only those optional periods for which a lessee has a significant economic incentive to extend a lease.
34. In the staff's view, the lease term threshold proposed in the 2013 ED is based on the substance of the lessee's contractual obligation (rather than the legal form of the contract). Accordingly, the lease term threshold proposed in the 2013 ED was intended to capture the substantive lease term. A lessee would have a significant economic incentive to exercise an option only when it would conclude that, economically, it cannot avoid exercising the option; that is, it is economically compelled to exercise the option. The staff note that the threshold proposed in the 2013 ED is consistent with the economic compulsion notion discussed in the IASB's 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.

35. The assessment of whether the lessee has a significant economic incentive to exercise an option is based on facts and circumstances at lease commencement relevant to the decision the lessee will make to exercise or not to exercise an option, rather than on the lessee's intentions or past practice. An entity would assess whether the lessee has a significant economic incentive to exercise an option by considering all factors relevant to that assessment (that is, contract-based, asset-based, market-based and entity-based factors).
36. The boards have previously considered and rejected various approaches to accounting for options as described in Appendix C. The staff think that the feedback received on the 2013 ED indicates that the boards should not reconsider these approaches.
37. The staff recommend that the boards confirm the high threshold proposed in the 2013 ED because they think it results in the appropriate assessment of the lease term. The staff think that a lease term that captures only noncancellable periods and periods for which a lessee is economically compelled to extend a lease gives an accurate reflection of a lessee's rights and obligations under that lease.
38. Additionally, the staff think a high threshold based on significant economic incentive would be superior to other approaches in the determination of lease term because it would be:
- (a) Easier to apply. It is based on an objective assessment of the economics of a lease rather than more subjective judgements (such as management intent or likelihood of exercise), and
 - (b) Less costly than other approaches (for example, a component approach in which an entity would recognise the option separately and measure it at fair value).
39. The staff also note that constituents (including the majority of users) generally supported the high threshold proposed in the 2013 ED.
40. Conversely, some constituents raised concerns that the proposed guidance might result in a lessee changing its behaviour to recognise lower lease assets and lease liabilities by moving from leases with noncancellable lease terms to leases with options. A lessee would be able to exclude lease payments relating to renewal options

(for which the lessee does not have a significant economic incentive to exercise that option) from the measurement of lease assets and lease liabilities, even if it intends to exercise that option.

41. The staff think that the lease term threshold proposed in the 2013 ED would provide useful information by reflecting the economic differences between leases. This is because a lessee with a lease with a noncancellable lease term is in a different economic position (with different financial and operational risks) than a lessee with a lease with optional periods for which there is no economic incentive to extend the lease. Additionally, the staff note that there would often be a disincentive for lessees to shorten lease terms. This is because shortening the lease term would likely result in increased lease payments to compensate the lessor for the change in risk from contractually guaranteed payments to unguaranteed payments.
42. The staff note that many constituents were confused about how to assess the significant economic incentive threshold and how high the threshold would be. In any new lease guidance, the determination of the lease term is important because it would directly affect the amount of lease assets and lease liabilities recognised. Therefore, the staff think that it would be helpful to provide more Application Guidance and more explanation in the Basis for Conclusions of the final Standard clarifying that the significant economic incentive threshold is a high threshold. The threshold is intended only to capture options for which the lessee is economically compelled to extend (or not to terminate) the lease. The threshold is also intended to be applied in substantially the same manner as the threshold in current guidance.

Question 1

Do the boards agree that the threshold for determining the lease term in the final Standard should be a high threshold that is based on whether the lessee is economically compelled to exercise (or not to exercise) an option?

What terminology should be used to describe the lease term threshold?

43. In this section the staff assume that the boards agree with the staff recommendation of retaining the high threshold based on the lessee's economic compulsion to extend (or not to terminate) a lease, as discussed above.
44. This section discusses what terminology to use in the final Standard to describe the lease term threshold and whether the boards should make any changes to the significant economic incentive terminology that was proposed in the 2013 ED.
45. The staff think there are two options with regard to the terminology of the threshold in the final Standard:
 - (a) Retaining the terminology in existing leases guidance (that is, reasonably certain or reasonably assured). The boards could choose one converged phrase, or have the IFRS leases guidance use the reasonably certain terminology and the U.S. GAAP leases guidance use the reasonably assured terminology.
 - (b) Retaining the terminology proposed in the 2013 ED (that is, significant economic incentive).
46. In the Basis for Conclusions to the 2013 ED, the boards state that the proposed significant economic incentive threshold would be similar to the existing lease term thresholds in U.S. GAAP and IFRS. Therefore, the staff think the boards could consider retaining the existing terminology in U.S. GAAP and/or IFRS to describe that high threshold. The staff also think that the existing guidance in U.S. GAAP (see Appendix B) as well as the guidance in the IFRS and U.S. GAAP accounting manuals of the major accounting firms regarding the determination of lease term is consistent with how the boards intended the significant economic incentive threshold in the 2013 ED to be applied.
47. The staff think that the main advantage of retaining the existing terminology is that it would make clear that the lease term requirements should be applied in the same way

as they are under existing guidance, which would reduce any possible costs that would result from implementing new terminology.

48. The staff identified the following advantages of retaining the significant economic incentive terminology proposed in the 2013 ED:
- (a) If the boards concur with the view that the threshold for including options in the initial measurement of lease assets and lease liabilities is a high threshold based broadly on the notion of economic compulsion, then the term significant economic incentive would be the most accurate reflection of that intention. The threshold requires an assessment of whether a lessee has a significant *economic* incentive to exercise an option; it is more than simply an assessment of the likelihood of exercise. The staff also think we can augment the language used in the 2013 ED to clearly articulate how this threshold is intended to be applied.
 - (b) According to the forthcoming Revenue Recognition guidance, if an entity has an obligation to repurchase an asset at the customer's request (at a price that is lower than the original selling price of the asset), the entity would consider whether the customer has a *significant economic incentive* to exercise that right. It is the staff's understanding that the significant economic incentive concept used in the forthcoming Revenue Recognition guidance is consistent with the significant economic incentive concept used in the 2013 ED. The 2013 ED provides more detailed guidance on the significant economic incentive concept than in the forthcoming Revenue Recognition guidance. This is because the significant economic incentive concept in the forthcoming Revenue Recognition guidance applies only to a relatively narrow population of revenue contracts. If the boards intend the concept of significant economic incentive to be the same in the revenue guidance and in the leases guidance, the staff think that it would be preferable to align the terminology in the final leases guidance with the forthcoming Revenue Recognition guidance.
 - (c) IFRS and U.S. GAAP use different terminology in their respective existing guidance (that is, reasonably certain in IFRS and reasonably assured in U.S.

GAAP). Because the leases project is a joint project, the staff think that it would be preferable to use converged terminology for the lease term threshold. If the boards would like to use converged terminology, then the boards would have to decide which of the existing phrases to retain, that is, reasonably certain or reasonably assured. The staff highlight that retaining only one of the two phrases would provide transitional relief for either only IFRS preparers or only U.S. GAAP preparers.

- (d) Using the term significant economic incentive might lead to more consistent application of the lease term guidance than is achieved under existing requirements. This is because of the lack of guidance in IFRS on how to apply the reasonably certain concept and the different terminology in IFRS and U.S. GAAP. New terminology, along with additional application guidance, would require preparers to reconsider whether their policy for determining the lease term is applied appropriately and is consistent with the new guidance.

49. The staff recommend retaining the terminology as proposed in the 2013 ED (that is, significant economic incentive) for the reasons listed above.

Question 2

Do the boards agree to use the term significant economic incentive to describe the threshold for lease term?

Extension and termination options - reassessment

50. This section assumes that the boards agree with the staff recommendations for initial recognition.
51. The staff think there are two alternatives for the boards to consider with regard to the reassessment of the lease term:
- (a) Approach 1: Requiring reassessment only upon the occurrence of a significant event or a significant change in circumstances; or
- (b) Approach 2: Not requiring reassessment.

52. The staff do not think that the boards should consider confirming the reassessment requirements proposed in the 2013 ED. The 2013 ED proposed that a lessee would reassess the lease term only if there is a change in relevant factors that would result in the lessee having or no longer having a significant economic incentive to exercise an option. Because the threshold proposed in the 2013 ED was described as a high threshold, the boards' intent was that it would generally require a significant change in relevant factors to conclude that a lessee would or would no longer have a significant economic incentive to exercise an option.
53. Nonetheless, responses in comment letters and outreach meetings indicated that constituents did not interpret the 2013 ED reassessment proposals to be applied as intended by the boards. Some constituents were concerned that an entity would have to continuously assess and monitor relevant factors that give rise to a significant economic incentive even though there might not be a change in the lease term. Constituents in comment letters and outreach meetings also mentioned there would be costs involved in demonstrating to their auditors that assumptions regarding a significant economic incentive have not changed even when they determined that no reassessment was necessary.
54. Given this feedback, the staff think that, if the boards wish to retain a reassessment requirement in the final standard, they should replace the reassessment requirements in the 2013 ED with a requirement for the lessee to reassess the lease term only in particular circumstances (as described in Approach 1). The staff think that this will significantly reduce the costs of reassessment as compared to how many constituents interpreted the 2013 ED proposals, while still providing users with timely financial statement information relating to significant events or significant changes in circumstances.
55. The staff also considered but rejected broadening the reassessment proposals in the 2013 ED, so that a change in market-based factors would trigger reassessment. The boards rejected such an approach because the lease term could change frequently as market prices change. The staff note that market-based factors are likely to change more frequently than other factors. There would be increased cost resulting from monitoring market-based factors and any corresponding remeasurement of lease

assets and lease liabilities. In addition, a majority of users consulted would not view this as providing more relevant information.

Approach 1

56. Under Approach 1, an entity would reassess the lease term only upon the occurrence of a significant event or a significant change in circumstances that would directly affect whether the lessee has a significant economic incentive. Approach 1 would *not* require a lessee to reassess the lease term on a continual basis. Instead the lessee's ongoing efforts would consist solely of monitoring for *significant* events or changes in circumstances ("triggering events") and, only then, reassess the lease term. Under Approach 1, consistent with the 2013 ED, a significant change in market-based factors would not, in isolation, trigger reassessment.
57. Approach 1 would be similar to the approach taken for the impairment of long-lived assets (other than goodwill and indefinite-lived intangible assets) in IAS 36 *Impairment of Assets* and Topic 360, Property, Plant, and Equipment. IAS 36 and Topic 360 do not require impairment testing except when there has been an indication that an asset may be impaired (IFRS) or circumstances indicate the carrying value of an asset may not be recoverable (U.S. GAAP). IAS 36 and Topic 360 each provide a list of example triggering events that indicate when an asset may be impaired.
58. Similar to IAS 36 and Topic 360, Approach 1 would include example triggering events. Tentatively, the staff have drafted the following example triggering events:
- (a) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease, or to purchase the asset, becomes exercisable;
 - (b) Making significant modifications or customisations to the asset being leased;
 - (c) Experiencing a significant positive or adverse change in business and/or macroeconomic conditions directly relevant to the asset being leased (for example, a significant downturn or upturn in demand for an entity's goods or services when the leased asset is integral to the delivery thereof); or

- (d) Subleasing the underlying asset for a period beyond the exercise date of the renewal option in the lease.
59. A major advantage of Approach 1 is that it provides more accurate and timely information than Approach 2 about significant changes in a lessee's rights and obligations. Approach 1 would do so by requiring reassessment when significant events or significant changes in circumstances occur that would directly affect whether the lessee has a significant economic incentive to exercise (or not exercise) an option. Supporters of Approach 1 note that users who commented on the reassessment proposals in the 2013 ED generally agreed with the concept of reassessment in order to provide more accurate financial information.
60. Another advantage of Approach 1 is that it provides cost relief for preparers by limiting the circumstances in which reassessment would be required as compared to the proposals in the 2013 ED. The staff think that the types of triggering events included above are of such a significant nature that it would be apparent when they occur. Moreover, the processes necessary to capture *significant* events or changes in circumstances would be less sophisticated than those that would be necessary to monitor for any changes in relevant factors.
61. Additionally, in Agenda Paper 3F/FASB Memo 273, the staff recommend including portfolio guidance in any new leases guidance, permitting an entity to apply the requirements on a portfolio basis (rather than on a contract-by-contract basis). If the boards adopt that staff recommendation, this might further reduce the costs of Approach 1. Lessees would be able to evaluate significant events or significant changes in circumstances (and any resulting reassessment) at a portfolio level. For example, if a lessee has determined that it can account for 1,000 leased machines as a single lease portfolio based on the proposed portfolio guidance, making a modification or customisation to one, or only a relatively small number, of those machines would generally not be considered a significant change in circumstances that would affect the assessment of whether the lessee has a significant economic incentive to exercise an option. Conversely, a series of asset modifications made to the entire fleet of leased machines may be a change that indicates that the lessee would be compelled to renew the lease of these machines.

62. A disadvantage of Approach 1 is that it would *not* provide the same level of cost relief as Approach 2. Under Approach 1, preparers would still be required to maintain appropriate policies and procedures to capture significant events or significant changes in circumstances such as those included as examples above.
63. The staff also note that it would be impossible to provide a complete list of all the significant events or significant changes in circumstances that should trigger reassessment. As a result, preparers might treat the indicators listed as examples of significant events or circumstances as a checklist rather than solely as examples. However, the staff note that the use of example triggering events is well established in both IFRS and U.S. GAAP impairment guidance.

Approach 2

64. Approach 2 would not require reassessment of the lease term after lease commencement.
65. The staff identified the following advantages of Approach 2:
- (a) Approach 2 would remove the cost and complexity associated with reassessing the lease term. The staff think it is valuable to provide significant cost relief in this area because the benefits of reassessing the lease term might be limited in many circumstances. This is because the significant economic incentive threshold is a high threshold, and therefore the assessment of lease term should change relatively infrequently. The staff note that lease term reassessment was one of the areas in the 2013 ED that was most frequently identified as being costly and complex, with little corresponding benefit.
 - (b) Although the staff acknowledge that the assessment of significant economic incentive could change, the staff note that removing the reassessment requirements would mainly affect the timing of when the adjustments to lease assets and lease liabilities are recognised. In general, the lease term would be more likely to change closer to the exercise date of an option. This is because as the exercise date of an option approaches, there are less variables that could affect whether the lessee has a significant economic

incentive to exercise that option. One could argue that the benefits of the timing difference in the recognition of lease assets and lease liabilities (that is, when the assessment of significant economic incentive changes rather than when an option is exercised) would not justify the potentially significant costs of reassessment.

66. Although the staff do not expect the significant economic incentive assessment would change very often, the staff acknowledge that the assessment could change. For those cases, removing any requirement to reassess the lease term could mean that the financial statements would not appropriately reflect the lessee's lease assets and lease liabilities. For example, assume a lessee enters into a five-year lease with a three-year renewal option. At lease commencement, the lessee concludes that it does not have a significant economic incentive to exercise the renewal option and concludes that the lease term is five years. However, in Year 4, the lessee decides to sublease the asset for a period of four years and concludes that it now has a significant economic incentive to exercise the renewal option. If there were no requirements for reassessment of the lease term, the change in the underlying economics would not be depicted at the time the change occurs but rather when the option is exercised. This may mean that one or more sets of financial statements issued by the lessee (for example, those issued at the end of Year 4) would not reflect the most accurate lease liability.

Staff recommendation

67. Some staff recommend Approach 2 because they think Approach 2 strikes the appropriate balance between costs and benefits. Assuming that the boards agree with the staff recommendation for initial measurement, the lease term threshold will be a high threshold and, therefore, the lease term should change infrequently. Therefore, the staff members recommending Approach 2 do not think that the benefits of reassessment would outweigh the costs, even if reassessment is only required in particular circumstances.
68. These staff think that the lease term reassessment requirements represent an area of the 2013 ED where the boards could remove a significant amount of complexity from

the proposals with a small corresponding reduction in the benefits of information provided about an entity's leasing activities.

69. The staff that support Approach 2 are not convinced that Approach 1 would provide sufficient cost relief. The staff note that a list of examples of particular triggering events such as those described above is not exhaustive. A lessee would, therefore, have to apply judgement in determining whether significant events or significant changes in circumstances beyond the examples included in this paper should trigger a reassessment of the lease term. These staff highlight that such judgement would incur at least some cost.
70. In addition, there is an argument to say that, having determined the substantive lease term at lease commencement, that lease term should not change. Any exercise of an extension option not included in the original lease term should be treated as a new lease. Before commencement of a new lease, a lessee may have a significant economic incentive to enter into that lease. Indeed, the lessee may even have signed the lease some time before the lease commences. Nonetheless, a lessee would not recognise lease assets and liabilities arising from that new lease until lease commencement. Accordingly, accounting for an extension option not included in the original lease term only when the option is exercised is consistent with the accounting for a new lease.
71. Other staff think Approach 1 strikes the appropriate balance between costs and benefits. These staff note that users have generally supported the notion of reassessment. Under existing IFRS and U.S. GAAP, reassessment of the lease term has minimal effect, primarily because lease assets and lease liabilities are not recognised on the lessee's balance sheet for most leases. Under the lessee accounting proposals in the 2013 ED, as well as any of the lessee accounting models discussed in Agenda Paper 3A/FASB Memo 268, the accuracy of the lease term directly affects the completeness and accuracy of the lessee's balance sheet and, to varied extents, the income statement. Consequently, these staff members see significant benefit in retaining a requirement to reassess the lease term when significant events or significant changes in circumstances make clear that the existing lease term may not be accurate. Without any reassessment, the balance sheet in particular may be

materially misstated (potentially for many reporting periods) until a renewal option that the lessee knows that it will be economically compelled to exercise is exercised.

72. From a cost perspective, those that support Approach 1 acknowledge that Approach 1 would be more costly to apply than Approach 2, but think that Approach 1 will be significantly less costly compared to how the reassessment requirements in the 2013 ED were interpreted by many constituents. This is because of its focus on *significant* events and circumstances to trigger a reassessment. These staff members also think that if the boards adopt the staff recommendation with respect to portfolio guidance in Agenda Paper 3F/FASB Memo 273, that will further reduce the costs of applying Approach 1. Staff members that support Approach 1 think that it represents clearer guidance than that proposed in the 2013 ED and works in a manner similar to existing IFRS and U.S. GAAP long-lived asset impairment guidance, which will be broadly familiar to preparers.
73. Lastly, the staff members that support Approach 1 think that to the extent the boards conclude that a constructive obligation exists *at* lease commencement when the lessee has a significant economic incentive to exercise an option in the lease, there is no basis for concluding that a constructive obligation cannot arise *subsequent* to lease commencement (for example, one month later) under the same conditions. By way of example, one could question why a lessee's plan to construct significant leasehold improvements that will effectively compel the lessee to renew its lease creates a liability at lease commencement, but that same plan would not give rise to a liability if it is developed subsequent to lease commencement (as would be the case under Approach 2).

Question 5

Which approach to reassessment do the Boards prefer?

Purchase options

74. The 2013 ED proposed that purchase options should be accounted for in the same way as options to extend the lease in both initial and subsequent measurement. An entity

would include the exercise price of a purchase option in the measurement of lease assets and lease liabilities if the lessee has a significant economic incentive to exercise that option. The staff do not think that the feedback received on the 2013 ED indicates that the boards should reconsider this proposal.

75. The staff do not recommend making any changes to the boards' tentative decision that purchase options be accounted for in the same way as options to extend or terminate a lease in initial and subsequent measurement. Accordingly, the staff recommend that any decisions made with initial and subsequent measurement for extension or termination options should also apply to purchase options.

Question 6

Do the boards agree purchase options should be accounted for in the same way as options to extend or terminate the lease?

Symmetry between lessee and lessor accounting for options

76. The 2013 ED does not make a distinction between a lessee and a lessor when accounting for options.
77. The staff highlight the following reasons that might support establishing different guidance for lessees and lessors in the accounting for options to extend or terminate a lease:
- (a) A lessee and lessor may not have the same information available about whether the lessee will exercise an option. This is particularly true for lessee-specific factors. The exercise of an option is usually within the control of the lessee, rather than the lessor. A lessor might, therefore, face challenges in determining the lease term and may not determine the same lease term for the same lease as the lessee.
 - (b) Because of the lessor's limited information, the assessment of whether there are any changes in the lease term might be particularly subjective.
78. However, the staff note that there are other aspects of the proposals that will often differ between the lessor and the lessee (for example, the discount rate – a lessee may

use its incremental borrowing rate, which will likely differ from the implicit rate in the lease used by the lessor). The staff do not think it is necessary, and in fact may be impossible, to ensure that the lessor and the lessee use the same lease term for all leases.

79. Therefore, on balance, the staff recommend that the lessee and lessor use the same guidance to determine the lease term. The staff make this recommendation for the following reasons:

- (a) The same guidance on lease term for lessees and lessors would be simpler to apply and understand, which may be helpful to users of financial statements.
- (b) When considering contract-based factors, a lessee and lessor would usually have the same information available to them.
- (c) The staff acknowledge that it might be more difficult for a lessor to assess whether the lessee has a significant economic incentive to exercise an option with respect to asset-based factors and entity-based factors. However, the staff note that for leases of big ticket or highly specialised items, the lessor would often have a good understanding of the lessee's business and should be in the position to assess whether the lessee has a significant economic incentive.
- (d) The staff recommendation would be consistent with existing requirements, which also requires a lessor to assess the lease term from the lessee's perspective.

80. In addition, the staff note that if the boards adopt any one of the lessor accounting models proposed in Agenda Paper 3C/FASB Memo 270, a lessor would not recognise a lease receivable for most leases and would generally recognise lease revenue ratably over the lease term. Therefore, the effect of lease term on lessors will generally be substantially less than its effects on lessees.

Appendix A – The proposals in the 2013 ED

A1. Below, the staff have included the definitions of lease term and corresponding lease term guidance proposed in the 2013 ED.

A2. The proposed definition of lease term in paragraph 25-27 of the 2013 ED is as follows:

25 An entity shall determine the *lease term* as the non-cancellable period of the lease, together with both of the following:

- (a) periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.

A3. The guidance to determine the lease term in the 2013 ED is as follows:

26 At the commencement date, an entity shall consider contract-based, asset-based, entity-based and market-based factors when assessing whether a lessee has a significant economic incentive either to exercise an option to extend a lease, or not to exercise an option to terminate a lease, as described in paragraph B5. Those factors shall be considered together and the existence of any one factor does not necessarily signify that a lessee has a significant economic incentive to exercise, or not to exercise, the option.

27 An entity shall reassess the lease term only if either of the following occurs:

- (a) there is a change in relevant factors, as described in paragraph B6, that would result in the lessee having or no longer having a significant economic incentive either to exercise an option to extend the lease or not to exercise an option to terminate the lease. A change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term.
- (b) the lessee does either of the following:
 - (i) elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so; or
 - (ii) does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

A4. The 2013 ED included additional guidance to determine the lease term in the Application Guidance:

B5 At the commencement date, an entity assesses whether the lessee has a significant economic incentive to exercise, or not to exercise, an option by considering all factors relevant to that assessment—contract-based, asset-based, market-based and entity-based factors. An entity’s assessment will often require the consideration of a combination of those factors because they are interrelated. Examples of factors to consider include, but are not limited to, any of the following:

- (a) contractual terms and conditions for the optional periods compared with current market rates, such as:
 - (i) the amount of lease payments in any optional period;
 - (ii) the amount of any variable lease payments or other contingent payments such as payments under termination penalties and residual value guarantees; and
 - (iii) the terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- (b) significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable;
- (c) costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee’s operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location; and
- (d) the importance of that underlying asset to the lessee’s operations, considering, for example, whether the underlying asset is a specialised asset and the location of the underlying asset.

B6 An entity shall reassess whether the lessee has, or does not have, a significant economic incentive to exercise, or not to exercise, an option if there is a change in relevant factors as described in paragraph B5. However, a change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment.

A5. Below is the paragraph in the Basis for Conclusions that describes the significant economic incentive threshold.

BC140 On reconsideration, the boards affirmed their view that the lease term should reflect an entity’s reasonable expectation of what the term would be. However, on the basis of the feedback received, they have changed the proposals so that the basis of that reasonable expectation of the lease term is linked to a lessee having a significant economic incentive to exercise an option. The boards note that applying the concept of ‘significant economic incentive’ would provide a

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threshold that is similar to the concepts of ‘reasonably assured’ and ‘reasonably certain’ in existing US GAAP and IFRS, which the boards understand work well in practice. However, there would need to be a significant economic incentive for the lessee to exercise the option in order to include optional periods in the lease term. An expectation of exercise alone (and without any economic incentive to do so) would not be sufficient. The boards concluded that requiring an economic incentive provides a threshold that can be applied more easily because it is more objective than a threshold based solely on management’s estimates or intent.

Appendix B – Existing guidance on lease term in IAS 17 and Topic 840

B1. The staff have included the current definitions of lease term below.

(a) IFRS: The definition of lease term under IAS 17 is as follows:

the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

(b) US GAAP: The US GAAP definition of lease term is more detailed but has the same basic principle as IFRS. US GAAP defines lease term as:

The fixed noncancelable lease term plus all of the following (except the lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable):

- a. All periods, if any, covered by bargain renewal options.
- b. All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be **reasonably assured**.
- c. All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:
 - i. A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.
 - ii. A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.
- d. All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.
- e. All periods, if any, representing renewals or extensions of the lease at the lessor's option.

B2. US GAAP defines a “penalty” as:

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:

- f. Disburse cash
- g. Incur or assume a liability

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- h. Perform services
- i. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:
 1. The uniqueness of purpose or location of the property
 2. The availability of a comparable replacement property
 3. The relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers
 4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property
 5. Adverse tax consequences
 6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

B3. IAS 17 and Topic 840 do not require the reassessment of lease term.

Appendix C – Alternatives previously considered and rejected by the boards

C1. Paragraph 137 of the Basis for Conclusions to the 2013 ED discusses the different approaches that were previously considered and rejected by the boards and the reasons why they were rejected.

BC137 There are a number of different ways that a lessee and lessor could reflect options that exist in leases:

- (a) a components approach, in which options in a lease are recognised and measured as separate components of the lease. The boards rejected a components approach to lease accounting because such an approach would be complex, would ignore the interrelationship between the term of a lease and the exercise of options, and would be difficult to apply because options may be difficult to measure reliably.
- (b) a disclosure approach, in which an entity recognises a lease liability or lease receivable for the non-cancellable period and discloses the existence of any options to extend the term. Although simple to apply, the boards rejected this approach because it would provide less useful information to users of financial statements. The measurement of lease assets and lease liabilities would ignore the existence of options, including those that are virtually certain of being exercised and, thus, would potentially misrepresent the assets and liabilities arising from a lease.
- (c) a measurement approach, in which options in a lease are included in the measurement of lease assets and lease liabilities using a particular method. That method could be, for example:
 - (i) a probability-weighted measurement method (in which the measurement of lease assets and lease liabilities reflects the probability of each possible lease term);
 - (ii) a probability threshold method (in which an entity includes optional periods in the lease term if the exercise of the options meets a specified threshold, for example reasonably certain, virtually certain, more likely than not); or

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(iii) an economic incentive method (in which an entity includes optional periods in the lease term if an entity has an economic incentive to exercise the option).

- C2. According to paragraph 120(c) of the Basis for Conclusions to the 2010 ED the boards rejected a probability-weighted approach, because it might be difficult to measure reliably the probability of exercise of an option, and to avoid an entity recognising a lease term that does not reflect a possible outcome, which some find counter-intuitive.
- C3. Based on the feedback received on the 2010 ED, the boards also rejected a ‘more likely than not’ measurement approach. This is because such an approach would have required subjective judgment and estimation that would have made the determination of the lease term excessively complex and costly.