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STAFF PAPER

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Project	**Leases**		
Paper topic	Variable Lease Payments		
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Objective

1. The purpose of this paper is to discuss the initial and subsequent measurement of variable lease payments within lease assets and lease liabilities. Agenda Paper 3C/FASB Memo 279 discusses the accounting for variable lease payments that are in-substance fixed lease payments; therefore, this paper does not discuss those payments.

2. This paper is structured as follows:

    (a) Background

    (b) Summary of Feedback on the 2013 ED

    (c) Staff Analysis and Staff Recommendations

        (i) Variable Lease Payments – Initial Measurement

        (ii) Variable Lease Payments – Subsequent Measurement

    (d) Appendix A – The Proposals in the 2013 ED

    (e) Appendix B – Summary of Existing Guidance in U.S. GAAP and IFRS.

3. In this paper, the staff recommend that:

   (a) The initial measurement of variable lease payments included in lease assets and lease liabilities includes only variable lease payments that depend on an index or a rate, measured using the index or rate at lease commencement.

   (b) A lessee would reassess variable lease payments that depend on an index or a rate only when it is reassessing the lease liability for other reasons (for example, when there is a change to the lease term upon the occurrence of a significant event or a significant change in circumstances within the control of the lessee).

Background

4. The 2013 ED proposed that a lessee and a lessor measure lease assets and lease liabilities on a basis that includes fixed lease payments and variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate) but excludes other variable lease payments unless those payments are in-substance fixed payments. The lessee and lessor would measure variable lease payments that depend on an index or a rate using the index or rate at lease commencement. An entity would recognize all other variable lease payments in profit or loss in the period incurred (or earned).

5. The 2013 ED proposed that an entity would reassess the measurement if there is a change in the index or rate used to determine lease payments.

6. Those proposals were different from the 2010 ED that proposed that an entity would include an estimate of all variable lease payments in the measurement of lease assets and lease liabilities, and would reassess those estimates.

Summary of Feedback on the 2013 ED

7. Most constituents, including most users, agree with the changes made to the 2010 ED proposals about the accounting for variable lease payments. Constituents generally said that variable payments contingent on future events (for example, performance or

use) do not represent a present obligation of the lessee nor a right of the lessor and, therefore, do not meet the definition of an asset or a liability. These constituents agree that an entity should recognize variable lease payments (that do not depend on an index or a rate) in profit or loss in the period incurred (or earned). In addition, many constituents, including most users, said that they would not want subjective estimates about variable lease payments reflected in the measurement of lease assets and lease liabilities.

8. A representative quote from the comment letters is as follows:

> In our view the proposals on initial measurement of variable lease payments are a pragmatic solution to a difficult issue. We recognise that as a result of those proposals the actual lease payments a lessee is obligated to make may exceed the estimated lease payments used in measuring assets and liabilities of the lessee and lessor. However, the proposals demonstrate the sharing of risk between a lessee and lessor that is reflected in variable lease payments. In addition, there are many lease arrangements (e.g. leases of retail space with rentals that are a percentage of the lessee's sales, sometimes with lease payments that are entirely contingent on sales) in which there is significant uncertainty about the timing and amount of variable lease payments. We believe that uncertainty increases the potential complexity and cost of estimating variable lease payments while reducing the potential benefits of such estimates. We agree that disclosure of the basis, terms and conditions on which variable lease payments are determined is a more appropriate alternative than recognition and measurement of such payments. (CL 199 – *Accounting Firm*)

9. Conversely, some constituents request that the Boards revert to the proposals for variable lease payments in the 2010 ED. These constituents think that:

   (a) It is the *measurement* of future variable lease payments that is uncertain, not the *existence* of the asset or the liability. Some note that the measurement of variable lease payments is no more difficult than, for example, determining the fair value of in-process research and development in a business combination. Excluding those payments could result in a significant understatement of a lessee's liability and a lessor's receivable.

(b) Estimates are inherent in lease accounting, such as the proposals for residual value guarantees. Accordingly, an entity should treat variable lease payments that do not depend on an index or a rate in the same way as other lease payments (that is, include estimates of such payments in the measurement of the lease asset and lease liability).

(c) Lessees entering into leases with variable payments must have some reliable estimate of their expected lease payments; otherwise, they would not enter into such leases.

10. A representative quote from the comment letters is as follows:

> We do not support with the exclusion of variable payments linked to sales or use as proposed in the Revised ED. This approach is inconsistent with the recognition threshold for other standards related to liability recognition. It is also not clear whether this approach is consistent with the revenue recognition approach in the recognition and measurement of contingent and variable revenue.
>
> It is important that there is separate disclosure of the variable lease payments, regardless of whether these are included in the measurement of the lease obligation. (CL 620 – *Large User Group*)

11. Many constituents conceptually support the inclusion of variable lease payments that depend on an index or a rate as proposed in the 2013 ED. These constituents said that it is appropriate to include such payments in the initial measurement of the lease assets and lease liabilities because the lessee has no ability to avoid variable payments that depend on an index or a rate.

12. However, some constituents think that the proposals might reduce comparability between entities if the terms and conditions of their leases differ, but the economics of

those leases are similar. Under the 2013 ED, a lessee with a lease with only variable lease payments (that do not depend on an index or a rate) would not be required to recognize a lease asset and a lease liability (even if the lessee expects to make lease payments of, for example, CU100 in each period). In contrast, a lessee with a similar lease with fixed lease payments of CU100 in each period would be required to recognize a lease asset and a lease liability. These constituents did not think that the accounting proposed in the 2013 ED would properly reflect what they view as economically similar leases.

13. With regards to reassessment of variable lease payments that depend on an index or a rate, some constituents support the reassessment proposals, including some users and a few preparers. However, almost all constituents expressed concerns about the reassessment proposals for variable lease payments from a cost and complexity perspective. Many added that they would not expect the proposed reassessment requirements to affect the income statement in any meaningful way. Consequently, they think that the cost of applying the reassessment proposals would outweigh any benefit.

14. A representative quote from the comment letters is as follows:

> Under the proposed guidance, lessees will record all leases on balance sheet, and must reassess the economic incentives associated with lease term extensions or lease termination options and rates used to record variable rents each reporting period, and re-measure the recorded lease asset and liability whenever there is a change, which for public companies could be as frequently as quarterly. This assessment and adjustment process, which must be performed at the individual leased asset level, will be unnecessarily burdensome and costly to implement and maintain. …Consistent with current accounting for contingent rents, changes in variable lease payments should be recorded in the period of change without re-measurement of the lease asset and liability. (CL 95 – *Large Preparer*)

15. A number of fieldwork participants also emphasized the costs and complexity associated with the reassessment of variable lease payments based on an index or a rate. In particular, one fieldwork participant noted that it has more than 6,000 retail leases, often with unique terms and conditions, many of which have variable lease payments that depend on an index or a rate. It would be a significant burden (for what they viewed as little benefit) to reassess lease payments for each of those leases that include payments that depend on an index or a rate at each reporting date.

Staff Analysis and Staff Recommendations

Variable Lease Payments – Initial Measurement

Which Payments Should be Included?

16. The 2013 ED proposed that an entity would include only variable lease payments that depend on an index or a rate in the initial measurement of lease assets and lease liabilities.

17. Variable lease payments that depend on an index or a rate meet the definition of an asset (for the lessor) and a liability (for the lessee) because they are unavoidable and, thus, economically are indistinguishable from fixed lease payments. At lease commencement, the lessee has a present obligation to make those lease payments and the lessor has a present right to receive those lease payments. Accordingly, any uncertainty associated with variable lease payments that depend on an index or a rate relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability. For these reasons, the staff recommend that such payments are included in the initial measurement of lease assets and lease liabilities.

18. There are different views on whether variable payments that do not depend on an index or a rate (such as those linked to future performance or use) meet the definition of a liability (for the lessee) and an asset (for the lessor):

    (a) Some are of the view that a lessee's liability to make, and a lessor's right to receive, variable lease payments do not exist until the future event requiring the payment occurs (for example, when the underlying asset is used or a sale is made). They highlight that variable lease payments linked to future performance or use can be viewed as a means by which the lessee and lessor can share future profits to be derived from the use of the underlying asset. Accordingly, they think that it is appropriate to exclude such variable lease payments from lease assets and lease liabilities until the future event occurs.

(b) Others are of the view that a lessee's obligation to make, and a lessor's right to receive, variable lease payments exist at lease commencement by virtue of the lease contract. They think that, in such instances, the measurement of the asset or liability may be uncertain but not the existence of the asset or liability. Nonetheless, some of those supporting this view may conclude that it is appropriate to exclude such payments from the measurement of lease assets and lease liabilities for cost benefit reasons.

19. In the staff's view, the 2013 ED appropriately measured lease assets and lease liabilities relating to variable lease payments at lease commencement. The staff think that the benefits of including variable lease payments that do not depend on an index or a rate (for example, variable lease payments based on performance or use) would not outweigh the costs of providing (preparers) or understanding (users) that information.

20. The feedback on the 2013 ED, as well as the 2010 ED, confirmed that it would often be very subjective to determine the expected variable lease payments that would be paid in future periods relating to future performance or use. That subjectivity would not only increase the costs and complexity of applying the requirements but also would have the potential to reduce the reliability of the amounts recognized and, thus, reduce the benefit of providing that information.

21. The staff also think that excluding variable lease payments that do not depend on an index or a rate may better reflect the flexibility and reduced risk that such payments provide to the lessee. The staff view variable lease payments based on future performance or use as a means by which the lessee and lessor can share future profits to be derived from the use of the underlying asset. Accordingly, the staff think that it

is appropriate to exclude such payments from the initial measurement of lease assets and lease liabilities.

22. Nonetheless, the staff acknowledge that, for those who think that variable lease payments based on performance or use create an asset (for the lessor) and a liability (for the lessee), an entity would understate lease assets and lease liabilities under this approach.

23. The staff also acknowledge that excluding variable lease payments that do not depend on an index or a rate from the measurement of lease assets and lease liabilities may create an incentive to restructure lease payments. For instance, a lessee could structure future leases to include a greater proportion of the total lease payments as variable payments (that do not depend on an index or rate) as opposed to fixed payments, which would reduce its reported lease liabilities.

24. However, on the basis of feedback received at outreach meetings, many lessors stated that they would *not* agree to changing payments from fixed to variable without making other changes to such contracts. Changing from fixed payments to variable payments would significantly increase the level of risk that the lessor would need to be willing to accept. As a result, lessors would likely increase the price of the lease to be compensated for that increase in risk. In addition, the staff think that a lessee is in a different economic position if it is obliged to make fixed lease payments (which are the same regardless of the benefits that it derives from use of the underlying asset) compared to making payments that depend on future performance or use of the underlying asset. The staff see benefit in reflecting those differing economics in the measurement of lease assets and lease liabilities.

25. Finally, the staff also think that requiring disclosures for variable lease payments that do not depend on an index or a rate (and, therefore, are not included in the measurement of lease assets or lease liabilities) is essential to providing relevant information to users of financial statements. This paper does not discuss disclosures about variable lease payments, which will be discussed at a future meeting.

How Variable Lease Payments should be Measured

26. The staff also recommend that, at lease commencement, an entity measures variable lease payments that depend on an index or a rate using the index or rate at lease commencement for cost benefit reasons, as was proposed in the 2013 ED. That is, an entity would initially measure lease assets and lease liabilities assuming no increase or decrease to future lease payments throughout the lease term. In principle, forecasting techniques should be used to determine the effect of changes in an index or a rate on the measurement of lease assets and lease liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that entities may not have readily available, and forecasts can be unreliable. For these reasons, the staff do not think that the additional information that would be provided as a result of forecasting would justify the costs of obtaining it.

27. In addition, measuring variable lease payments that depend on an index or a rate using the index or rate at lease commencement could be viewed as a means of including the minimum required lease payments in the measurement of lease assets and lease liabilities (consistent with the Boards' decision to exclude most payments in optional periods from the measurement of lease assets and lease liabilities). Although an index or a rate could be negative, it is relatively rare that this is the case. In addition, in some jurisdictions, variable lease payments that depend on an index or a rate have a floor such that those payments can never decrease. As such, the initial lease payments are likely to represent the minimum required lease payments in many leases that have variable lease payments that depend on an index or a rate.

Question 1: Variable Lease Payments – Initial Measurement
Question 1 - Do the Boards agree 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 and that an entity should measure those payments using the index or rate at lease commencement (consistent with what was proposed in the 2013 ED)?

Variable Lease Payments – Subsequent Measurement

28. The 2013 ED proposed that a lessee and a lessor would remeasure lease assets and lease liabilities to reflect changes to the *lease payments* if there is a change in the index or rate used to determine lease payments. Reassessment would be performed at each reporting period. An entity would determine the revised lease payments using the index or rate at the end of the reporting period.

29. The staff propose three alternatives for the Boards to consider with respect to the reassessment of variable lease payments that depend on an index or a rate:

    (a) Approach 1 – Require reassessment of these payments at each reporting period (as proposed in the 2013 ED).

    (b) Approach 2 – Require reassessment of these payments only when there is a contractual change in the cash flows (that is, at the time when an adjustment to lease payments takes effect). For example, if contractual lease payments change only every 3 years and the change is linked to the change in CPI during that 3-year period, under Approach 2, a lessee would reassess its lease liability only every 3 years when the contractual payments change. It would not reassess its lease liability at each intervening reporting date.

    (c) Approach 3 – Require reassessment of these payments only when the lease liability is reassessed for other reasons (that is, reassessment of the lease term or whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset).

    Note: Because the Boards tentatively decided not to require lessors to reassess the lease term or whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset, Approach 3 would not require a lessor to reassess its lease receivable for changes to an index or a rate used to determine lease payments.

30. The staff have organized this section by first analyzing whether to reassess, then by comparing the three alternatives, and finally by providing a staff recommendation.

Should There be Reassessment?

31. The staff think that requiring reassessment of the measurement of variable lease payments that depend on an index or a rate would provide timely and relevant information about lease assets and lease liabilities. This is because the reassessed value would reflect *current* economic conditions. In the 2013 ED, the Boards concluded that reassessment would be necessary to provide relevant information about lease assets and lease liabilities at each reporting date.

32. If the Boards agree with the staff recommendation to use the index or rate at lease commencement as the basis for initial measurement, not requiring reassessment of the index or rate would result in excluding changes to lease payments (that arise from changes to the index or rate) from the subsequent measurement of lease assets and lease liabilities. As noted earlier in this paper, an entity would initially measure lease assets and lease liabilities assuming no increase or decrease to future lease payments throughout the lease term. Consequently, if the Boards' objective is to reflect changes to variable lease payments that depend on an index or a rate within the measurement of lease assets and lease liabilities, then some form of reassessment would be necessary to provide that information.

33. Nonetheless, the staff and the Boards have received significant feedback about the cost and complexities associated with reassessing variable lease payments that depend on an index or a rate. In response to both the 2010 ED and the 2013 ED, many constituents noted that they did not think the benefits would outweigh the costs. In particular, many of those constituents noted that reassessing variable lease payments would generally not result in any significant differences in the amounts recognized in a lessee's income statement compared to not reassessing those variable lease payments.

Balance Sheet Effect

34. The examples below illustrate the difference in the measurement of a lessee's lease liability when comparing reassessing to not reassessing variable lease payments that depend on an index or a rate. The staff have assumed that under both examples the lease payments payable at the beginning of the first year is CU100,000, the discount

rate is 8 percent, and lease payments increase or decrease annually to reflect the annual change in CPI. The only difference between the examples is that one lease has a 5-year lease term and the other a 20-year lease term.

35. In each example:

(a) Base cash paid represents the assumed fixed payments at lease commencement; that is, the rent payable in the first year of the lease when the CPI index is 125.

(b) Actual cash paid represents the payments made by the lessee, increased in each year to reflect the increase in the CPI index.

(c) The lease liability is the lease liability without reassessment, measured assuming lease payments of CU100,000 in each year of the lease (paid at the beginning of the year).

(d) The reassessed liability is the lease liability remeasured at each year-end to reflect the increased lease payments in the following year (for example, at the end of year 1 of the 5-year lease, the lease liability is remeasured assuming lease payments of CU104,800 in each year of the remaining lease term).

Balance Sheet Effect - 5 Year Lease					
Year	*Base Cash*	*CPI Index*	*Actual Cash Paid*	*Lease Liability*	*Reassessed Liability*
0		125		431,213	431,213
1	100,000	131	100,000	357,710	374,880
2	100,000	132	104,800	278,326	293,913
3	100,000	138	105,600	192,593	212,622
4	100,000	140	110,400	100,000	112,000
5	100,000	143	112,000	0	0

36. In year 4 of the 5-year lease, if the lessee does not remeasure the lease liability, it would measure its lease liability at CU100,000. However, as a result of the variable lease payment increases, the lease payment to be made in year 5 is CU112,000. If reassessment were performed, the lease liability would be CU112,000 at the end of year 4, reflecting the actual cash to be paid in year 5.

Balance Sheet Effect - 20 Year Lease					
Year	*Base Cash*	*CPI Index*	*Actual Cash Paid*	*Lease Liability*	*Reassessed Liability*
0		125		1,060,360	1,060,360
1	100,000	131	100,000	1,037,189	1,086,974
2	100,000	132	104,800	1,012,164	1,068,845
3	100,000	138	105,600	985,137	1,087,591
4	100,000	140	110,400	955,948	1,070,662
5	100,000	143	112,000	924,424	1,057,541
6	100,000	147	114,400	890,378	1,047,084
7	100,000	150	117,600	853,608	1,024,329
8	100,000	155	120,000	813,896	1,009,232
9	100,000	158	124,000	771,008	974,554
10	100,000	159	126,400	724,689	921,804
11	100,000	161	127,200	674,664	868,967
12	100,000	163	128,800	620,637	809,311
13	100,000	164	130,400	562,288	737,722
14	100,000	168	131,200	499,271	671,020
15	100,000	173	134,400	431,213	596,798
16	100,000	179	138,400	357,710	512,240
17	100,000	180	143,200	278,326	400,790
18	100,000	182	144,000	192,593	280,415
19	100,000	184	145,600	100,000	147,200
20	100,000	187	147,200	0	0

37. Similarly, in the 20-year lease, if the lessee does not remeasure the lease liability, it would have a lease liability of CU100,000 in year 19, but would have a lease liability of CU147,200 if it were to remeasure the lease liability, reflecting the actual cash to be paid in year 20.

38. Nonetheless, reassessing the lease liability would *not* result in measuring the lease liability to reflect the actual future lease payments (unless the future lease payments could no longer change as is the case in year 19 of the 20-year lease). Instead, it would result in measuring the lease liability assuming that all future lease payments would equal the payment to be made in the next year. For example, in the 20-year lease example above, the reassessed liability at the end of year 8 is CU1,009,232, which is measured assuming that the annual lease payments to be made in years 9-20 would be CU124,000 (the payment to be made in year 9). For the reassessed liability

to reflect the actual lease payments made in years 9-20, the lease liability at the end of year 8 would have been CU1,082,901.

39. The staff think that, in particular, the 20-year lease example illustrates that reassessing variable lease payments that depend on an index or a rate at each reporting period (or when contractual payments change) would provide more useful information about the lessee's lease liability, assuming that such a lease would continue, unmodified, for the 20-year lease term. The 5-year lease example illustrates that, for shorter-term leases, there is not as significant a benefit in reassessing such variable lease payments. The staff also note that it is unlikely that the reassessed lease liability would represent the actual lease payments to be made throughout the remaining lease term (unless the lease is nearing its end and the future lease payments would no longer be subject to change).

Income Statement Effect

40. When a lessee does not reassess variable lease payments that depend on an index or a rate, it would recognize:
    - (a) All variable lease payments relating to the change in the index or rate after lease commencement separately from other lease expenses; and
    - (b) The full effect of the change in the index or rate in the period in which that change occurs.

41. In contrast, when a lessee reassesses variable lease payments that depend on an index or a rate at each reporting period, it would recognize:
    - (a) Most of the effects of changes to variable lease payments that depend on an index or a rate as part of the amortization and interest expense (for Type A leases) or the single lease expense (for Type B leases); and
    - (b) The effects of changes in the index or rate over future reporting periods, instead of recognizing the effects of those changes in full in the period in which the changes occur.

42. Using the 5-year and 20-year examples described above, the following tables set out the effects on the lessee's income statement under both Type A and Type B lessee accounting:

Income Statement Effect - 5 Year lease											
	Type A							*Type B*			
Year	*No reassessment*				*Reassessment*			*No reassessment*			*Reassessment*
	Amort	*VLPs*	*Interest*	*Total*	*Amort*	*Interest*	*Total*	*Lease exp*	*VLPs*	*Total*	*Lease exp*
1	86,243	-	26,497	112,740	86,243	26,497	112,740	100,000	-	100,000	100,000
2	86,243	4,800	20,617	111,659	90,535	21,606	112,141	100,000	4,800	104,800	104,800
3	86,243	5,600	14,266	106,109	91,277	15,065	106,342	100,000	5,600	105,600	105,600
4	86,243	10,400	7,407	104,050	95,899	8,178	104,077	100,000	10,400	110,400	110,400
5	86,243	12,000	0	98,243	97,499	0	97,499	100,000	12,000	112,000	112,000
Total	431,213	32,800	68,787	532,800	461,454	71,346	532,800	500,000	32,800	532,800	532,800

Income Statement Effect - 20 Year lease											
	Type A							*Type B*			
Year	*No reassessment*				*Reassessment*			*No reassessment*			*Reassessment*
	Amort	*VLPs*	*Interest*	*Total*	*Amort*	*Interest*	*Total*	*Lease exp*	*VLPs*	*Total*	*Lease exp*
1	53,018	-	76,829	129,847	53,018	76,829	129,847	100,000	-	100,000	100,000
2	53,018	4,800	74,975	132,793	55,638	78,574	134,212	100,000	4,800	104,800	104,800
3	53,018	5,600	72,973	131,591	56,088	77,060	133,148	100,000	5,600	105,600	105,600
4	53,018	10,400	70,811	134,229	58,870	78,175	137,045	100,000	10,400	110,400	110,400
5	53,018	12,000	68,476	133,494	59,826	76,693	136,519	100,000	12,000	112,000	112,000
6	53,018	14,400	65,954	133,372	61,305	75,451	136,756	100,000	14,400	114,400	114,400
7	53,018	17,600	63,230	133,848	63,340	74,359	137,699	100,000	17,600	117,600	117,600
8	53,018	20,000	60,289	133,307	64,916	72,346	137,262	100,000	20,000	120,000	120,000
9	53,018	24,000	57,112	134,130	67,629	70,819	138,447	100,000	24,000	124,000	124,000
10	53,018	26,400	53,681	133,099	69,311	67,852	137,163	100,000	26,400	126,400	126,400
11	53,018	27,200	49,975	130,193	69,891	63,568	133,459	100,000	27,200	127,200	127,200
12	53,018	28,800	45,973	127,791	71,090	59,213	130,303	100,000	28,800	128,800	128,800
13	53,018	30,400	41,651	125,069	72,331	54,313	126,644	100,000	30,400	130,400	130,400
14	53,018	31,200	36,983	121,201	72,974	48,522	121,496	100,000	31,200	131,200	131,200
15	53,018	34,400	31,942	119,360	75,637	42,930	118,566	100,000	34,400	134,400	134,400
16	53,018	38,400	26,497	117,915	79,086	36,672	115,758	100,000	38,400	138,400	138,400
17	53,018	43,200	20,617	116,835	83,379	29,523	112,902	100,000	43,200	143,200	143,200
18	53,018	44,000	14,266	111,284	84,121	20,543	104,664	100,000	44,000	144,000	144,000
19	53,018	45,600	7,407	106,025	85,662	10,785	96,447	100,000	45,600	145,600	145,600
20	53,018	47,200	0	100,218	87,262	0	87,262	100,000	47,200	147,200	147,200
Total	1,060,360	505,600	939,640	2,505,600	1,391,373	1,114,227	2,505,600	2,000,000	505,600	2,505,600	2,505,600

43. The examples above illustrate two points:

(a) For most years during the lease term, there is not a significant difference in the total amounts that a lessee would recognize in the income statement for Type A leases, and no difference for Type B leases.

(b) The staff think that recognizing the effects of changes in an index or a rate as an expense in the period in which that change occurs (that is, when there is no reassessment) provides the most useful information. This is because a lessee would present separately the effects of the change in the index or rate on lease payments in the period in which the change occurs (and would present these consistently with the effects of other variable lease payments).

Comparing the Three Alternatives

44. Both Approach 1 (which would reassess variable lease payments based on an index or rate at each reporting date) and Approach 2 (which would reassess those payments only when the contractual payments change) provide information about the effect of changes in variable lease payments after their initial measurement. The staff note that Approach 1 provides the most timely and relevant information about lease assets and lease liabilities because a lessee would reassess the lease liability at each reporting period. Consequently, Approach 1 is also the most complex and costly of the three approaches to apply because it would require the most frequent reassessment, potentially on a quarterly basis. This could be particularly onerous for lessees that have hundreds of leases, with largely unique terms and conditions, with variable lease payments that depend on an index or a rate. The unique nature of many property leases (which are those leases that the staff understand most frequently include such variable lease payments) would require many lessees to reassess these contracts on an individual lease basis.

45. Approach 2 would result in remeasuring lease assets and lease liabilities only when the contractual lease payments change. Some would view Approach 2 as providing less relevant information than Approach 1 because a lessee would not always remeasure the lease liability to reflect the relevant index or rate at each reporting date. Others would view Approach 2 as an effective way to update the asset and liability measurement to reflect changes to variable lease payments. This is because an entity would reassess lease assets and liabilities only when an entity already knows of the actual change in contractual lease payments payable in the immediate future. The staff think Approach 2 would be less complex and costly to apply than Approach 1. This is because a lessee would typically be expected to report its financial results more frequently than a contractual change in the cash flows of a lease with payments that depend on an index or a rate.

46. Approach 3 views the costs of reassessing variable lease payments that depend on an index or a rate as exceeding the benefits from such reassessment. Approach 3 provides the greatest cost and complexity relief to preparers by not requiring the remeasurement of lease payments unless the lessee remeasures the lease liability for other reasons (for example, because of a change in the lease term). In that case, the lessee would remeasure any variable lease payments that depend on an index or a rate using the index or rate at the date of remeasurement.

47. For all three approaches, a lessee would recognize and present variable lease payments that depend on an index or a rate not included in the lease liability, including any changes attributable to the current reporting period, in the same manner as any other variable lease payments (that is, in profit or loss). A lessee would recognize increases in the lease liability resulting from any reassessment of variable lease payments that depend on an index or a rate as an adjustment to the ROU asset.

Staff Recommendation

48. The staff recommend Approach 3 for cost-benefit reasons.

49. Although reassessing variable lease payments that depend on an index or a rate would provide more useful information about lease assets and lease liabilities (because it would provide a more faithful depiction of future lease payments than not reassessing), the staff think that the costs of requiring reassessment would outweigh the benefits in most circumstances for the following reasons:

    (a) Regarding costs, one of the most consistent comments received from constituents in response to the 2013 ED related to the costs and complexity of the reassessment requirements proposed in the 2013 ED. In particular, many constituents identified the reassessment of variable lease payments that depend on an index or a rate at each reporting period as one of the most complex (and costly) aspects of the 2013 ED proposals. Based on this feedback, it would appear that requiring the reassessment of variable lease payments under either Approach 1 or Approach 2 would potentially be significantly more costly and complex to apply than Approach 3. This has been demonstrated by constituents through examples in comment letters, publications, and at workshop and fieldwork meetings.

(b) Regarding benefits:

(i) The staff think that Approach 3 would provide more useful information in a lessee's income statement for Type A leases than either Approach 1 or Approach 2. This is because, under Approach 3, a lessee would reflect the change in lease payments resulting from a change in an index or a rate in its income statement in the period in which that change occurs (as demonstrated in the examples above, whether or not a lessee reassesses variable lease payments based on an index or rate will generally have no effect on the income statement for Type B leases).

(ii) The staff think that the benefits of reassessing the lease liability under Approaches 1 and 2 would be minimal compared to Approach 3 for many leases when considering the information provided about actual future payments. This is because the lease liability under Approaches 1 and 2 would not reflect the actual future lease payments (unless the lease is nearing an end and/or the future lease payments would no longer be subject to change), and, instead, it would assume that the current period lease payment will remain unchanged throughout the remaining lease term.

(iii) The staff understand that variable lease payments that depend on an index or a rate most frequently exist within property leases. The staff also understand that such property leases are frequently modified (some retailers and restaurateurs indicated that hundreds of their property leases are modified in each quarter). When a lease is modified, the staff are recommending in Agenda Paper 3A/FASB memo 278 that a lessee would update the contractual lease payments to reflect the modified lease terms and conditions. Consequently, in these situations, a lessee would reflect updated lease payments in the measurement of lease liabilities after commencement of the original lease without a requirement to reassess variable lease payments that depend on an index or a rate at each reporting date.

50. Under Approach 3, the staff recommend remeasuring variable lease payments that depend on an index or a rate when the lessee is remeasuring the lease liability for other reasons (for example, if reassessing the lease term in Year 7 of a 10-year lease). In these situations, it would likely be more difficult and costly to remeasure the lease payments using the index or rate used at lease commencement rather than the current index or rate. The staff also think it would make little sense for a lessee to use the rate that existed in the past when doing a current remeasurement of the lease payments. Use of the current index or rate would also appear appropriate if the lessee is reassessing the discount rate at that date (refer to Agenda paper 3D/280 for further discussion about the discount rate).

51. Finally, the staff think that a lessee can provide additional information about variable lease payments that depend on an index or a rate through disclosures (such as the terms of the variable lease payments and the current period expense). Disclosures will be discussed at a future meeting.

Questions 2-3: Variable Lease Payments – Subsequent Measurement
Question 2 - Do the Boards agree with the staff recommendation that lessees should reassess variable lease payments that depend on an index or a rate only when the lease payments are remeasured for other reasons (for example, because of a reassessment of the lease term)? Question 3 – Do the Boards agree with the staff recommendation that lessors should not reassess such payments?

Appendix A – The Proposals in the 2013 ED

A1. The following is the guidance for variable lease payments for both lessees and lessors that was proposed in the 2013 ED:

LESSEE

Initial Measurement of the Lease Payments Included in the Lease Liability

842-20-30-3 At the commencement date, the lease payments included in the lease liability shall consist of the following payments relating to the use of the **underlying asset** during the lease term (as described in paragraph 842-10-25-1) that are not yet paid:

a. Fixed payments, less any lease incentives receivable from the **lessor**
b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
c. Variable lease payments that are in-substance fixed payments (see paragraphs 842-20-55-45 through 55-52)
d. Amounts expected to be payable by the lessee under **residual value guarantees**
e. The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option (assessed considering the factors described in paragraph 842-10-55-4)
f. Payments for penalties for terminating the lease, if the lease term (as determined in accordance with paragraph 842-10-25-1) reflects the lessee exercising an option to terminate the lease.

Subsequent Measurement

842-20-35-2 After the commencement date, a lessee shall recognize in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics, all of the following:

a. For Type A **leases**, the unwinding of the discount on the lease liability as interest and the amortization of the right-of-use asset.
b. For Type B leases, a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, calculated so that the remaining cost of the lease (as described in paragraphs 842-20-55-7 through 55-8) is allocated over the remaining lease term on a straight-line basis. However, the periodic lease cost shall not be less than the periodic unwinding of the discount on the lease liability.
c. **Variable lease payments** not included in the lease liability in the period in which the obligation for those m payments is incurred.

Reassessment of the Lease Liability

842-20-35-4 After the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease payments as described in paragraph 842-20-35-5 and changes to the discount rate as described in paragraphs 842-20-35-6 through 35-7. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset, except as follows:

a. A lessee shall identify the amount of the remeasurement arising from a change in an index or a rate (as described in paragraph 842-20-35-5(d)) that is attributable to the current period and shall recognize that amount in profit or loss.
b. If the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

LESSOR (Type A)

Initial Measurement of the Lease Payments Included in the Lease Receivable

842-30-30-2 At the commencement date, the lease payments included in the lease receivable shall consist of the following payments relating to the use of the **underlying asset** during the **lease term** (as described in paragraph 842-10-25-1) that are not yet received:

a. Fixed payments, less any lease incentives payable to the **lessee**
b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
c. Variable lease payments that are in-substance fixed payments
d. Lease payments structured as **residual value guarantees** (as described in paragraphs 842-30-55-1 through 55-2)
e. The exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option (assessed considering the factors described in paragraph 842-10-55-4)
f. Payments for penalties for terminating the **lease**, if the lease term (as determined in accordance with paragraph 842-10-25-1) reflects the lessee exercising an option to terminate the lease.

Initial Measurement of the Residual Asset

842-30-30-4 At the commencement date, a lessor shall measure the residual asset as follows:

A + B – C

A = The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term, discounted using the rate the lessor charges the lessee (**gross residual asset**).

B = The present value of expected variable lease payments (as described in paragraph 842-30-30-5).

C = Any unearned profit, determined in accordance with paragraphs 842-30-30-6 through 30-8.

Variable Lease Payments Included in the Rate the Lessor Charges the Lessee

842-30-30-5 If a lessor reflects an expectation of variable lease payments in determining the rate the lessor charges the lessee and those payments are not included in the lease receivable, the lessor shall include in the initial measurement of the residual asset the present value of variable lease payments expected to be earned during the lease term, discounted using the rate the lessor charges the lessee.

Subsequent measurement

842-30-35-2 After the commencement date, a lessor shall recognize all of the following in profit or loss:

a. The unwinding of the discount on the lease receivable as interest income
b. The unwinding of the discount on the **gross residual asset** as interest income
c. Variable lease payments that are not included in the lease receivable in the periods in which that income is earned.

Reassessment of the Lease Receivable

842-30-35-4 A lessor shall reassess the lease payments if there is a change in any of the following:

a. The lease term, as described in paragraph 842-10-25-3. A lessor shall determine the revised lease payments on the basis of the revised lease term.
b. Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset, assessed in accordance with paragraph 842-10-55-5. A lessor shall determine the revised lease payments to reflect the change in amounts receivable under a purchase option.
c. An index or a rate used to determine lease payments during the reporting period. A lessor shall determine the revised lease payments using the index or rate at the end of the reporting period.

842-30-35-5 A lessor shall reassess the discount rate if there is a change in any of the following, unless the possibility of change was reflected in determining the discount rate at the commencement date:

a. The lease term
b. Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset
c. A reference interest rate, if variable lease payments are determined using that rate.

Subsequent Measurement of the Residual Asset

842-30-35-8 If a lessor includes variable lease payments in the initial measurement of the residual asset in accordance with paragraph 842-30-30-4, the lessor shall derecognize a portion of the carrying amount of the residual asset in each period and recognize a corresponding expense in profit or loss. The lessor shall determine the portion to derecognize on the basis of the variable lease payments expected to be earned in the period (as described in paragraphs 842-30-55-3 through 55-5).

842-30-35-9 See paragraphs 842-30-55-3 through 55-5 for implementation guidance on variable lease payments included in the rate a lessor charges a lessee for Type A **leases.**

Application of Variable Lease Payments Included in the Rate the Lessor Charges the Lessee for Type A Leases

842-30-55-3 If a lessor includes **variable lease payments** in the initial measurement of the residual asset in accordance with paragraph 842-30-30-5, paragraph 842-30-35-8 requires the lessor to derecognize a portion of the carrying amount of the residual asset in each period and recognize a corresponding expense in profit or loss.

842-30-55-4 At the **commencement date**, a lessor should calculate the portion of the residual asset to derecognize in each period on the basis of the expected variable lease payments as follows:

$$\frac{A}{B} \times C \times \frac{D}{E}$$

A = The amount of variable lease payments expected to be earned in the current period reflected in determining the **rate the lessor charges the lessee**.

B = The amount of total variable lease payments expected to be earned during the lease term reflected in determining the rate the lessor charges the lessee.

C = The amount of the initial measurement of the residual asset relating to variable lease payments (that is, the present value of variable lease payments expected to be earned during the lease term, discounted using the rate the lessor charges the lessee).

D = The carrying amount of the underlying asset immediately before the commencement date.

E = The fair value of the underlying asset at the commencement date.

842-30-55-5 Changes in estimates relating to variable lease payments do not affect the amounts to be derecognized by the lessor in each period. A lessor should recognize any difference between expected and actual variable lease payments in profit or loss in the reporting period.

Appendix B: Summary of Existing Guidance in U.S. GAAP and IFRS

Lessees

B1. Existing leases guidance in Topic 840 (originally issued as EITF Issue 98-9) states that:

> A lessee shall recognize contingent rental expense (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the contingent rental expense, provided that achievement of that target is considered probable. (840-10-25-35)

B2. IAS 17 states that contingent rents should be charged as expenses in the periods in which they are incurred.

Capital (Finance) Leases

B3. The guidance in Topic 840 (and similar guidance in IAS 17) states that a lessee is required to disclose:

a. The total contingent rentals actually incurred for each period presented.

b. The basis on which contingent rental payments are determined.

Operating Leases

B4. The guidance in Topic 840 (and similar guidance in IAS 17) states that a lessee is required to disclose, for all operating leases:

a. Rental expense for each period presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals.

b. The basis on which contingent rental payments are determined.

Lessors

B5. Existing leases guidance in Topic 840 (originally issued in EITF Issue 98-9) states that a lessor should defer recognition of contingent rental income until the specified target is met, consistent with SAB 101 on revenue recognition. Additionally, Topic 840 states that:

> The lessor shall disclose its accounting policy for contingent rental income. If a lessor accrues contingent rental income before the lessee's achievement of the specified target (provided achievement of that target is considered probable), disclosure of the impact on rental income shall be made as if the lessor's accounting policy was to defer contingent rental income until the specified target is met. (840-10-50-5)

B6. Similar guidance does not exist in IFRS.

Capital (Finance) Leases

B7. Existing leases guidance in Topic 840 (and similar guidance in IAS 17) states that, for sales-type leases and direct financing leases (finance leases in IAS 17), a lessor is required to recognize contingent rentals as income in the period in which it relates. Additionally, a lessor is required to disclose information on total contingent rentals included in income for each period presented.

Operating Leases

B8. For all operating leases, a lessor is required to disclose total contingent rentals included in income for each period presented.