MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Leases Team (Chesney x447)
Subject:	Minutes of the October 17, 2007 Board Meeting: Other Lessee Obligations and Variable Lease Payments — **Date:** November 8, 2007
cc:	FASB: Bielstein, Golden, MacDonald, Lott, T. Johnson, Zeyher, Nickell, Roberge, Chesney, C. Smith, Glotzer, Gabriele, Hoyt, Allen, Sutay, Klimek, FASB Intranet; FASAC: Chookaszian, Posta; IASB: Upton, Hickey, Knubley, Peerless; GASB: Driscoll

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Topic:	Other Lessee Obligations and Variable Lease Payments
Basis for Discussion:	Memorandum #13 (IASB Agenda Paper 12A) and Memorandum #14 (IASB Agenda Paper 12B)
Length of Discussion:	8:45–10:00 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Linsmeier, Seidman, Smith, and Young
Board members absent:	None
Staff in charge of topic:	Zeyher
Other staff at Board table:	Bielstein, T. Johnson, Nickell, and Chesney
Outside participants:	None

Summary of Decisions Reached:

The Board discussed a staff analysis of lease arrangements, which includes lessee obligations to incur costs to return the leased item, return the leased item in a specified condition, and maintain the leased item.

The Board considered whether these obligations meet the definition of a liability and, if so, when the liability arises. The Board also considered how the debit arising upon recognition of the liability should be treated, how the liability should be measured, and whether these obligations give rise to assets for the lessor.

The Board discussed a staff analysis of lease payments with a variable factor based on price changes or an index, the lessee's financial or operating performance from the leased item, and the lessee's use of the leased item.

The Board considered whether these variable lease payments meet the definition of a liability and, if so, when the liability arises and how it should be measured.

This meeting was informational, and no decisions were reached.

Objective of Meeting:

The purpose of this informational meeting was to solicit Board members' views and tentative conclusions, as well as obtain direction from the Board regarding the staff's next steps.

Matters Discussed:

OTHER LESSEE OBLIGATIONS

1. The Board was reminded of its previous tentative conclusion that the lessee's obligation to return the leased item at the end of the lease term does not meet the definition of a liability; however, the lease terms may give rise to other obligations related to the return of the leased item that might meet the definition of a liability. The staff analyzed three types of such obligations, which are the lessee's obligation to incur costs to return the leased item, to return the item in a specified condition, or to maintain the leased item.

Type 1: Lessee Obligations to Incur Costs to Return the Leased Item

Liability for the Lessee

2. The staff recommended that obligations to incur costs to return the leased item meet the definition of a liability for the lessee when the lessee obtains access to the leased item (in the case of transportation costs) or when the machinery is installed (in the case of an obligation to dismantle). The Board generally agreed with the staff's recommendation.
3. Ms. Seidman noted that the staff placed much of the basis for its conclusions on the fact that the lease is in the form of a contract, and that the lessee has a liability because it has a contractual agreement to incur these costs. However, the outflows related to the costs to return the leased item generally do not go to the lessor (for example, the lessee might hire a trucking company to return the leased item, or for Type 2 and Type 3 obligations, the lessee might hire a maintenance contractor).
4. Ms. Seidman questioned whether lessors would look to the contractual nature of the obligation and conclude that they have an asset. She noted the lessor's asset might be less likely to be impaired as a result of the lessee undertaking these obligations; however, she did not think the lessor would have an incremental asset related to these items.
5. Ms. Bielstein noted the lessor could have an asset representing the right to have the lessee transport the leased asset to a specific location (and the lessor would then be able to avoid those costs). Mr. Linsmeier and Mr. Smith noted these items would affect the residual value of the asset. Ms. Seidman noted that the character of the obligations mentioned above is very different from that of the obligation to make lease payments.
6. Ms. Seidman noted whether or not the lessor has a discrete asset could depend on how the lessor has been accounting for the leased asset. If the lessor accounting model did not reflect any change in the location of the asset (that is, if the underlying property, plant, and equipment were to remain on the books of the lessor), it might influence the conclusion of whether or not the lessor has a discrete asset related to costs to return the leased item.
7. Ms. Seidman noted that there could be a lack of symmetry between the lessee's accounting and the lessor's accounting; however, Mr. Smith noted there was not a

requirement that the accounting be symmetrical. He does not consider whether the liability is separate a major issue and that costs to return the leased item are similar to asset retirement obligations.

8. Mr. Linsmeier observed that the Board should decide whether costs to return the leased item are a separate liability (because the costs may be paid to someone other than the lessor) from the liability for lease payments to the lessor or if both obligations are a single liability. He noted that this conclusion (separate or single liability) could affect discussions regarding measurement of the liability. He noted that if the unit of account is the lease contract, then these obligations (which are all a part of the same lease contract) would be a single liability and there should be symmetry in measurement for those liabilities.
9. Ms. Seidman agreed that whether the liability is separate is important because it seems as though it is the lease contract that is driving the conclusion that these items are present obligations of the lessee; however, she indicated that her initial view was that the lease is a multi-element contract and that she was not sure all the liabilities would be accounted for in the same way. Mr. Smith noted that Type 1 obligations are distinctly different from the Type 2 and Type 3 obligations.
10. Mr. Herz noted that the staff's examples assume that the costs are unavoidable, which may not always be true (for example, if the lease contained a purchase option). Ms. Zeyher noted that the analysis would be different if the lease contained a purchase or renewal option. Ms. Bielstein added that there would still be an unavoidable outflow if there was a purchase or renewal option (it would be a question of whether the outflow was to purchase the asset or to incur costs to return the asset). The Board generally agreed with the staff's recommendation.

Accounting for the Debit

11. The staff has not yet developed a recommendation on the accounting for the debit because the Board has not reached a conclusion on its initial and subsequent measurement of a lessee's right of use asset. The Board generally agreed that it needs to

make a decision regarding the accounting for the right of use asset before it can make a decision about the debit side of the liability.

12. Mr. Herz stated that, although he would initially assume the debit was an expense, his decision depends on whether the asset is based on a cost accumulation model (which might justify capitalizing the cost similar to an asset retirement obligation [ARO)]) or a fair value model.
13. Ms. Seidman thought these costs might be distinguishable from the liability to make lease payments. These costs were not negotiated between the lessee and lessor.
14. Mr. Linsmeier questioned whether the costs to transport the leased asset to the lessee would be paid by the lessee or the lessor. He stated these costs were probably built into the lease payments if they were not separately paid by the lessee and the same would most likely be true for the transportation costs at the end of the lease term. He noted that there should be symmetry between the accounting for the installation costs and the transportation and removal costs. If the transportation and removal costs are included as part of the asset, then the installation costs also should be included. He noted this would be consistent with a cost accumulation model.
15. Mr. Linsmeier observed that the Board should consider any potential asymmetry between the asset and liability when making its decision regarding the debit; if the liability is measured at fair value and transaction costs are expensed, then the transaction costs should be expensed on the asset side as well (which might not be consistent with a cost accumulation model). If the Board pursues a cost model, it might be difficult to account for certain items such as renewal or purchase options.
16. Ms. Seidman noted that (even under a property, plant and equipment [PP&E] model) the fair value of the asset may at times be easier to determine than the fair value of a liability with variable terms. She noted that this should be revisited when the elements of the entire model are in place.

Type 2 and Type 3: Lessee Obligations to Return the Leased Item in a Specified Condition and Lessee Obligations to Maintain the Leased Item

Liability for the Lessee and Accounting for the Debit

17. Some staff members recommended that the Type 2 and Type 3 obligations meet the definition of a liability when the lessee obtains access to the leased item. Other staff members recommended that, except in situations where it is clear that the lessee has little or no discretion to avoid an outflow of economic benefits, no liability is recognized until the event that would require an outflow of economic benefits actually occurs. The staff did not have a recommendation for the accounting for the debit.
18. Ms. Seidman noted that the amount paid when the specified condition is met for a Type 2 obligation or Type 3 obligation is fundamentally different from the contractual lease payments. Mr. Linsmeier agreed with Ms. Seidman, stating that there is no present obligation until the leased asset is in the condition that would require the lessee (under the contract) to perform the required maintenance. He noted this is different from a Type 1 obligation, where installing the item obligates the lessee to incur costs to uninstall the item—the obligating event (installation) has already occurred for Type 1 obligations. Mr. Linsmeier stated that the costs to return the property to the specified condition are maintenance costs not specifically tied to the lessee's right of use asset; the lessee should expense these costs in the period during which the asset fell below the condition and triggered the recognition of the obligation.
19. Mr. Smith observed that the staff's analysis assumes entities would not make uneconomic decisions (that is, not use an asset that they are leasing) to avoid falling below the specified condition. He cited as an example companies in the airline industry that will cease using a plane to avoid the engine going beyond a machine hour limit (which would trigger an additional maintenance charge under the lease). He noted that in certain fact patterns there are opportunities to avoid some of these costs.
20. Mr. Nickell noted that the basis for FASB Staff Position (FSP) AUGAIR-1, *Accounting for Planned Major Maintenance Activities*, was that an airline could avoid the obligation by not using the asset; however, the FSP did make a distinction for situations where a

contract obligated the entity to perform the maintenance. He noted that the key question is whether the lease contract could be considered the obligating event.

21. Mr. Linsmeier observed that this is more a recognition issue than a measurement issue. Mr. Smith questioned what the difference would be if Type 2 and Type 3 obligations were the responsibility of the lessee or if they were the responsibility of the lessor and the costs were included in the lease payments. Mr. Smith questioned whether the lease payments would be bifurcated to show the maintenance portion separately.
22. Mr. Linsmeier noted that if the lessee has a choice of whether or not to operate the asset (and thus incur the Type 2 or Type 3 costs), then the lessee does not have a present obligation until the threshold is reached. He noted if the lease terms are such that the lessor pays the Type 2 or Type 3 costs, then the contractual lease payments (which are an obligation to the lessee) will reflect these costs, regardless of whether they will actually be incurred by the lessor. In that case, the present obligation to make lease payments (which includes these costs) is incurred at the signing of the lease. He stated that this is similar to the transportation costs related to Type 1 obligations, and that the accounting might be different if the lessee has the choice to avoid these costs.
23. Mr. Young questioned whether economic compulsion would indicate the lessee could not avoid the costs (that is, if the asset is so valuable to the lessee's business that they are compelled to use it). Ms. Seidman observed that this would lead to fundamental differences in the accounting for maintenance between leased assets and owned assets. Mr. Linsmeier stated that economic compulsion does not create a present obligation and is not part of the definition of a liability.
24. Messrs. Batavick, Herz, Linsmeier, and Smith and Ms. Seidman agreed that if contractual, these costs are an obligation to the lessee once the property falls below the threshold (when they are contractually unavoidable), regardless of whether the maintenance has been performed. This could be different from an owner of the asset who might not expense the cost until the actual maintenance is performed (because there would be no separate contract that triggers the obligation once the asset reaches a certain usage level).
25. However, Ms. Seidman and Mr. Smith added that they were troubled by the different results that might come about depending on how the lease is structured. Additionally,

Ms. Seidman observed that where the debit is recorded is not clear without knowing what the model is for the right of use asset.

26. Mr. Herz noted Type 2 and Type 3 obligations were more in the nature of maintenance costs, whereas the Type 1 obligation is more a cost incurred to obtain the asset. He also noted that in a PP&E model, Type 2 and Type 3 obligations seem more like maintenance of the asset (as opposed to an enhancement).
27. Ms. Seidman questioned whether the costs for Type 2 and Type 3 leases would be similar to AROs. Mr. Linsmeier and Mr. Herz noted that Type 2 and Type 3 obligations are not AROs because there is no legal obligation to pay these costs at day one (no obligation until the condition requiring the maintenance has been reached). Mr. Herz stated that these questions depend on what the right to use asset is and how it is accounted for.
28. Mr. Linsmeier noted that there should be a holistic look at how the asset and liability are accounted for, and whether all the relevant assets and liabilities are accounted for separately. A simplistic model would have one measurement basis that is symmetric across assets and liabilities recognized.
29. Mr. Nickell noted that the current lease accounting literature requires that maintenance, insurance, and taxes be separated from the lease payments and accounted for separately. He indicated that the same notion could be applied to Type 2 and Type 3 costs by acknowledging that even if a liability has been incurred, it is not part of the liability for the right to use asset (and thus one would expense that amount rather than capitalize it as part of the right to use asset).
30. Ms. Zeyher noted it seemed as though Board members thought there should be similar measurement attributes for all liabilities under the lease contract. Mr. Linsmeier noted that although he expressed that concern, he was not sure other Board members shared that concern. Ms. Seidman did not agree; she believed there was a fundamental difference between a monetary obligation to make lease payments and an estimate of costs that would be incurred to perform certain activities at the end of the lease (or during the lease).

Measurement of the Liability

31. The staff recommended that any liabilities related to the three types of obligations should be initially and subsequently recorded at fair value. Messrs. Batavick, Herz, Seidman, and Smith agreed that for Type 2 and Type 3 obligations the lessee's liability should be recorded at expected cost. Mr. Batavick added that the liability should be the amount the lessee expects to pay to perform the maintenance or the amount the lessee expects to pay someone else to perform the maintenance; risk premiums or discounts and the credit risk of any third parties should not be factored into the measurement of this liability. Mr. Crooch noted that he prefers fair value measurement. The Board did not specifically address measurement of Type 1 obligations.

Assets for the Lessor

32. The staff recommended that the lessor's rights related to the lessee's obligation to incur these costs are not a separate asset, although they would impact the measurement of the lessor's interest in the leased item at the end of the lease. Therefore, these rights should be combined with the asset representing the lessor's interest in the leased item at the end of the lease. Ms. Seidman noted there should be a question about whether the lessor has a separate asset related to these costs.

VARIABLE LEASE PAYMENTS

Category 1: Lease Payments with a Variable Factor Based on Price Changes or an Index

Liability for the Lessee and Measurement of the Liability

33. The staff recommended that the lessee has an asset reflecting its right to use the equipment over the lease term and a liability for its unconditional obligation to make fixed payments, adjusted for changes in prices or an index, over the lease term. The staff recommended that the obligation initially be recorded at fair value. The carrying value of the liability should be adjusted for changes in the expected rental payments, which should

be discounted using the original interest rate (calculated at initial measurement). Alternatively, the liability could be subsequently measured at fair value (adjusted for all expected changes in the amount payable including changes in market interest rates and the lessee's credit).

34. Mr. Linsmeier noted, particularly for Category 1, that the question should focus on measurement as opposed to recognition. He stated that there is a present obligation to make lease payments and questioned why FASB memo no. 14 seemed to imply that two liabilities existed (a fixed obligation and a variable obligation) when there is really only one liability to make lease payments. He noted that the one liability happens to have a variable element which presents a measurement question, but not a recognition question. Ms. Seidman agreed that a present obligation exists in Category 1 leases.
35. Regarding measurement, Ms. Seidman noted (and Mr. Smith agreed), that the answer might depend on the decision about measurement of the right to use asset and whether or not there is a desire for symmetry between the asset and the liability. She noted that these questions might need to be reconsidered based on decisions made on these topics. Ms. Seidman observed that the situation in Category 1 is a little easier to think about because financial variables are involved; however, she noted there might be situations where the value of the right to use asset rather than the liability may result in more reliable measurements. She provided an example of a lease with very low fixed rents and very high contingent rents when there is a known market rental rate in the particular location. She noted in that fact pattern that it might be more reliable to determine the right to use asset based on the known market rental rate (and then impute the liability from that). She acknowledged a difference between a lease with fixed rents and a lease with a high amount of contingent rent, and she didn't believe the accounting should be the same (but the right to use asset might be the same). Ms. Bielstein noted that this presents a question of whether the Board wants to measure the fair value of the asset and the fair value of the liability independently, or use whichever fair value is more clearly determinable to impute the fair value of the related asset or liability.
36. Ms. Seidman and Mr. Linsmeier both observed that there are symmetry issues regarding the right of use asset and related liability that the Board should address. In other words, the Board should decide whether the asset and liability initially should be recorded at the

same amount. Mr. Herz noted the concerns with symmetry are mostly focused on day one symmetry.

37. Mr. Herz added that the effects of entering into a lease with variable lease payments, whether those effects are positive or negative, should be reflected in the financial statements. Ms. Bielstein noted that the measurement could incorporate the uncertainty about whether the effects will be positive or negative.

Category 2: Lease Payments with a Variable Factor Based on the Lessee's Financial or Operating Performance from the Leased Item

38. Mr. Linsmeier and Mr. Smith stated that there was no liability for Category 2 leases until the condition triggering the variable rentals is reached. Ms. Zeyher noted that two examples were presented to the Board. Example C required the lessee to use the leased asset (that is, open and operate the store); however, Example D did not include an enforceable agreement requiring the lessee to use the leased asset. The staff did not understand if the Board believed this difference should result in different accounting. Mr. Smith did not think there was a distinction between Examples C and D.
39. Mr. Linsmeier stated there was no present obligation until the condition obligating the variable rental payments is reached in either Example C or Example D. He stated this conclusion was consistent with the Board's discussion of other lessee obligations in Topic 1.
40. Ms. Seidman questioned whether or not it is possible for a lessor to require a lessee to operate a store. Mr. Nickell cited as an example lease agreements in the retail industry where a lease could stipulate that the lessee is required to operate during certain hours and in a certain manner. Ms. Seidman inquired if it was common for contingent rents to exist in that fact pattern. Mr. Nickell indicated it would be very unusual for a lease to have 100 percent (or another very high percentage) contingent rents based on sales, but to not have any requirement that the lessee use the leased property. He said a fact pattern where 100 percent contingent rentals could exist would be a small tenant that pays contingent rents until an anchor tenant opens (at which time the lease payments would change to fixed rentals). Mr. Linsmeier reiterated that there is no present obligation until

the lessee hits the sales target (in a situation where the rent is contingent based on a percentage of sales) and there is not an unconditional stand-ready obligation.

41. Mr. Nickell had a concern with this view from the perspective of the lessee's right to use asset. He questioned the conclusion that a lessee would have no right to use asset in a lease where the lessee has a very high percentage of contingent rents and it would virtually be assured or highly probable that the lessee would reach the target for the contingency. He indicated the economics could be very similar between this type of lease and a lease with fixed rents. Mr. Linsmeier noted there is a contractual difference between the two leases.
42. Ms. Seidman questioned whether the reasoning behind not recording a liability was because the condition triggering the additional rents was performance related (as opposed to Category 1 leases). Ms. Seidman noted it could center on the question of whether or not the lessee has the discretion to avoid the obligation. She also noted that current guidance requires financial options to be recognized without regard to when the market price exceeds the strike price (which the parties to the option do not have discretion over).
43. Ms. Bielstein noted a similar example was included as part of the conceptual framework project discussion regarding the definition of an asset (in which it was the staff's conclusion that the lessor did have an asset). She noted this question should be considered from the lessee and lessor's perspectives.
44. Mr. Linsmeier noted the lessor does not have an enforceable right to the rentals until the lessee achieves the sales target. Mr. Herz noted that from the lessor's perspective there is an enforceable right to receive the rentals if the lessee hits the sales target. He also noted the right is enforceable, and another Board member commented that it could be exchanged for cash.
45. Mr. Batavick said that initially he held the view that there was no present obligation until the sales target was reached, but he was still contemplating the comments that were made. Mr. Smith indicated that initially he held the view that there was a present obligation before the lessee reached the sales target; however, he was still considering the example of a small tenant that only pays contingent rents until an anchor tenant arrives. Mr. Linsmeier indicated that the discussion of these variable rents was inconsistent with

the discussion of other lessee obligations related to maintenance where the Board stated there was not an obligation until the specified maintenance condition is reached.

46. Ms. Bielstein questioned whether the right to use asset is worth nothing (and therefore there is no right of use asset) when the rents are completely variable based on sales. She also questioned if there would be a gain if one concluded an asset existed for the right of use, but no liability if the rents are completely variable. This result may question whether it makes sense for no recognition of the liability until the lessee reaches the sales target. Ms. Seidman also questioned whether there would be no right to use asset in that example. Mr. Linsmeier indicated the asset recorded would depend on whether a cost-based or fair-value based model is used for measuring the lessee's right to use. The asset would be zero under a cost-based model.
47. Mr. Herz suggested recording the best estimate of the liability at the beginning of the lease term. Ms. Bielstein noted this was different than the view being discussed by Mr. Linsmeier.
48. Mr. Linsmeier indicated this discussion relates to the unit of account issue. In other words, is the lease contract the unit of account? If so, the current discussion should focus more on measurement rather than recognition. Mr. Linsmeier believed FASB memo no. 14 was written in a way that indicates there are two liabilities (a liability for the fixed payments and a liability for the variable payments).
49. Ms. Seidman also noted that the discussion would put tension on the Board's initial conclusion that the obligation to make leased payments is a financial liability. Mr. Linsmeier noted that one could potentially have obligations to the lessor as a financial liability and obligations to other parties as a non-financial liability.

Category 3: Lease Payments with a Variable Factor Based on the Lessee's Usage

Liability for the Lessee and Measurement of the Liability

50. The staff recommended that, at inception of the lease, the lessee have an asset representing the right to use the leased property for the lease term, a liability representing the unconditional obligation to pay the fixed rentals, and an unconditional stand-ready

obligation to pay the additional variable rentals. If the lessee has the discretion to avoid using the leased property throughout the lease term, the lessee may not have an initial obligation for the variable lease payments; rather, this obligation is incurred when the lessee exercise its option to used the leased property.

51. Ms. Seidman asked for clarification on why the staff analyzed Category 3 leases similar to leases with a renewal option as opposed to Category 2 leases. She questioned if it was because in Category 2 the lessor could require the lessee to use the asset. Ms. Zeyher noted there was a difference in the lessee's discretion to use the asset and that Category 3 is essentially an option to acquire more of the right to use the asset.

52. Mr. Nickell clarified that Category 3 leases are very similar to leases with a renewal option. In a typical lease, the renewal option is an option to acquire more years or more time; however, in Category 3 the option is to either acquire more miles (in an automobile lease) or more machine hours. He clarified that in Category 2 the variable payments are not contingent on the lessee exercising an option to acquire more usage (the period or amount that the lessee can use the asset for is fixed in Category 2; however, there is contingent consideration that the lessee will pay for that usage that is based on the lessee's sales).

53. Mr. Smith felt Category 3 was distinctly different than Category 2. He did not believe there was an obligation for the contingent rents in Category 3 until the target that triggered them was hit. He did note that the conclusion could be different if the lease provisions were non-substantive. Mr. Nickell cited a hypothetical example of an automobile lease that requires rent of 1 dollar per mile for the first 5 miles, but 10 million dollars for the sixth mile.

54. Mr. Linsmeier noted that the call option analysis was not provided for the other lessee obligations examples in Type 2 and Type 3 obligations discussed earlier. He noted that in Type 2 and Type 3 obligations there is no call option, but a written option from the lessee that states if the leased asset goes beyond a certain condition that the lessee will pay a certain amount. He noted there was no analysis that considered booking an option up front for the maintenance obligations. Ms. Bielstein noted this was alluded to in the staff's reference to the Type 2 and Type 3 obligations representing something akin to an insurance contract.

55. Mr. Nickell noted there are similarities between the Category 3 leases and the obligations for maintenance payments. One could argue that both represent payments to compensate the lessor for additional wear and tear on the leased asset.

56. Ms. Zeyher noted it seems that the Board wants the staff to (a) further analyze the model for the right of use asset, (b) what the unit of account is, (c) whether initial and subsequent measurement of liabilities (and assets) under the lease contract should be consistent, and (d) whether the asset and liability will be accounted for similarly.

57. Ms. Seidman stated that the staff should prioritize those issues before proceeding with work on more detailed areas that are currently in the lease project plan. She also indicated there should be a basic discussion about the lessor's accounting including where the initial debits and credits are recorded. Mr. Linsmeier agreed, noting that the Board should circle back to these core issues before proceeding to other issues. Ms. Bielstein noted that the sequencing of the project will be discussed at the next Board advisors meeting for the leasing project.

58. Mr. Herz added that the staff should consider the effects on earnings of the different measurement alternatives (much of the discussion was related to the balance sheet). He cited as an example the lessee booking (up front) contingent rents based on sales, but not recording the sales up front. He noted this could be looked at as similar to a minority interest in the store's sales. He felt there should be some consideration to items that are being currently accounted for that will not occur until a point in the future.