

Statement of Financial Accounting Standards No. 29

[FAS29 Status Page](#)
[FAS29 Summary](#)

Determining Contingent Rentals
an amendment of FASB Statement No. 13

June 1979



Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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CONTENTS

	Paragraph Numbers
Introduction and Background Information.....	1–9
Standards of Financial Accounting and Reporting:	
Amendments to FASB Statement No. 13.....	10–13
Effective Date and Transition.....	14
Appendix A: Illustrations of the Application of the Provisions of This Statement	15–17

FAS 29: Determining Contingent Rentals an amendment of FASB Statement No. 13

FAS 29 Summary

The Board has been asked to reconsider the definition of contingent rentals in *FASB Statement No. 13*, "Accounting for Leases," because differing views about the meaning of that definition result in similar leases being accounted for differently, for example, as a capital lease by one lessee and as an operating lease by another lessee. This Statement defines contingent rentals as the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors on which lease payments are based. Lease payments that depend on a factor that exists and is measurable at the inception of the lease, such as the prime interest rate, would be included in minimum lease payments based on the factor at the inception of the lease. Lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue.

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked whether lease payments that depend on changes in a factor that is measurable at the inception of the lease should be included in minimum lease payments for purposes of lease classification, accounting, and reporting under *FASB Statement No. 13*, "Accounting for Leases." Examples of factors upon which lease payments can be based include sales volume in a leased facility, an interest rate such as the prime rate, or an index such as a construction cost index or consumer price index.
2. Paragraph 16(a)(iv) of *FASB Statement No. 13* refers to contingent rentals as "rentals on which the amounts are dependent on some factor other than the passage of time." Footnote 13 of Statement No. 13 further states that "the term 'contingent rentals' includes all or any portion of the stipulated rental that is contingent."

3. In specifying the accounting for capital leases by lessees, paragraph 12 of *FASB Statement No. 13* states that "contingent rentals,... including rentals based on variables such as the prime interest rate, shall be charged to expense when actually incurred." Paragraphs 17(b) and 18(b) of Statement No. 13 include similar reference to contingent rentals in specifying the accounting by lessors for sales-type leases and direct financing leases.

4. The Board has been advised that diverse accounting practices have developed with respect to determining contingent rentals. The following three practices have been identified: (a) all lease payments that depend on factors that can change are considered contingent rentals and are excluded from minimum lease payments in their entirety, (b) lease payments that depend on such factors are included in minimum lease payments to the extent that payment by the lessee is assessed as probable, and (c) only the amounts based on a measurable factor existing at the inception of the lease are included in minimum lease payments. Under the last approach, lease payments that depend on a factor like future sales volume of a leased facility are contingent rentals in their entirety and are excluded from minimum lease payments because future sales do not exist at the inception of the lease. Supporters of this approach point out that lease payments based on future sales should be excluded from minimum lease payments because those payments would terminate if the lessee discontinues use of the leased facility.

5. The diverse accounting practices described in the preceding paragraph cause different amounts to be included in minimum lease payments for similar leases. Because the amount of minimum lease payments affects the classification and accounting for leases, such diverse practices result in similar leases being classified and accounted for differently. For example, a lease may be classified as a capital lease by one lessee and a similar lease classified as an operating lease by another lessee because of differing views about the definition of contingent rentals.

6. An Exposure Draft of a proposed Statement on "Determining Contingent Rentals" was issued for public comment on December 21, 1978. The Board received 37 letters of comment in response to the Exposure Draft.

7. Several respondents stated that contingent rentals should be included in minimum lease payments to the extent that payment by the lessee is probable. The Board rejected that approach primarily because of the subjectivity inherent in estimating probable contingent rentals. However, the Board noted that, if certain rental payments to the lessor were required rather than probable under the terms of the lease or other agreement, *FASB Statement No. 13* requires that such payments be included in minimum lease payments.

8. The Board has considered various accounting practices with respect to determining contingent rentals and has concluded that lease payments that depend on factors that exist and are measurable at the inception of the lease should be included in minimum lease payments. The Board believes that the term *contingent rentals* contemplates an uncertainty about **future changes** in the factors on which lease payments are based. Accordingly, the Board has

concluded that *FASB Statement No. 13* should be amended to identify the contingency in that way.

9. The Board has concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraph 14 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 13

10. The following footnote is added to the end of the first sentence of paragraph 5(j)(i) of *FASB Statement No. 13*:

Contingent rentals as defined by paragraph 5(n) of *FASB Statement No. 13* shall be excluded from minimum lease payments.

11. Paragraph 5 of FASB Statement No. 13 is amended by adding the following subparagraph:

- n. *Contingent rentals.* The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or pre-construction period, as discussed in *FASB Statement No. 23*, "Inception of the Lease," shall be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable.

12. Footnote 13 and the parenthetical phrase following *contingent rentals* in paragraph 16(a)(iv) of *FASB Statement No. 13* are deleted.

13. The last sentence of paragraphs 12, 17(b), and 18(b) of *FASB Statement No. 13* is superseded by the following:

Contingent rentals shall be included in the determination of income as accruable.

Effective Date and Transition

14. The provisions of this amendment to *FASB Statement No. 13* shall be effective for leasing transactions recorded and lease agreement revisions (see paragraph 9 of Statement No. 13) recorded as of October 1, 1979 or thereafter. Earlier application is encouraged. In addition, except as provided in the next sentence, the provisions of this Statement shall be applied retroactively at the same time and in the same manner as the provisions of Statement No. 13 are applied retroactively (see paragraphs 49 and 51 of Statement No. 13). Enterprises that have already applied the provisions of Statement No. 13 retroactively and have published annual financial statements based on the retroactively adjusted accounts before the effective date of this Statement may, but are not required to, apply the provisions of this Statement retroactively.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: ILLUSTRATIONS OF THE APPLICATION OF THE PROVISIONS OF THIS STATEMENT

15. This Appendix illustrates the application of the provisions of paragraphs 10-13 of this Statement in determining contingent rentals. The examples do not comprehend all possible combinations of circumstances.

16. Paragraph 11 of this Statement indicates that lease payments that depend on an existing index or rate, such as the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease. As an example, an equipment lease

could stipulate a monthly base rental of \$2,000 and a monthly supplemental rental of \$15 for each percentage point in the prime interest rate in effect at the beginning of each month. If the prime interest rate at the inception of the lease is 10 percent, minimum lease payments would be based on a monthly rental of \$2,150 [$\$2,000 + (\$15 \times 10) = \$2,150$]. If the lease term is 48 months and no executory costs are included in the rentals, minimum lease payments would be \$103,200 [$\$2,150 \times 48$]. If the lease is classified as a capital lease and the prime interest rate subsequently increases to 11 percent, the \$15 increase in the monthly rentals would be a contingent rental included in the determination of income as it accrues. If the prime interest rate subsequently decreases to 9 percent, the \$15 reduction in the monthly rentals would affect income as accruable. In the case of either the increase or decrease, minimum lease payments would continue to be \$103,200.

17. Paragraph 11 of this Statement also indicates that lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours or use of sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. For example, a lease agreement for retail store space could stipulate a monthly base rental of \$200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of \$25,000 for the past 2 years, minimum lease payments would include only the \$200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at the inception of the lease, and future rentals would be limited to \$200 per month if the store were subsequently closed and no sales were made thereafter.