International
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This document is provided as a convenience to observers at IASB/FASB joint international working group meeting on leasing, to assist them in following the working group's discussion. It does not represent an official position of the IASB or the FASB. IASB and FASB Board positions are set out in their respective Standards.

Note: These notes are based on the staff paper prepared for the IASB/FASB working group. Paragraph numbers correspond to paragraph numbers used in the staff paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Meeting:	**Joint International Working Group on Leasing** **15 February 2007, London**
Topic:	**IDENTIFICATION OF ASSETS AND LIABILITIES ARISING IN A SIMPLE LEASE (Agenda Paper 5)**

Introduction

1. The purpose of this paper is to identify the assets and liabilities that arise in a simple lease contract.[1] This paper does not consider the recognition or measurement of the assets and liabilities identified (this will be considered at a later stage of the project).
2. The paper starts by examining the rights and obligations of the lessee and lessor that arise from the exchange of promises in a simplified lease contract. We then consider whether these rights, obligations, and promises meet the definitions of assets and liabilities in the IASB Framework and FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6). This paper also considers whether the exchange of promises give rise to assets and liabilities under the revised definitions of assets and liabilities proposed in the Conceptual Framework project.

[1] The definition of a lease and the scope of the proposals are considered later.

3. In reality, lease contracts are often significantly more complex than the lease described in this paper. However, by analysing a simple lease, the staff believes it can identify the rights and obligations that are common to all lease contracts. More complex lease terms will be considered at a later stage. In order to simplify the analysis, this paper only considers those rights and obligations that exist after the leased item has been delivered to the lessee. Assets and liabilities may arise prior to the delivery of the leased item (for example, when the lease contract is signed). The timing of recognition is discussed in paper 8.

Promises exchanged and rights and obligations arising in a simple lease

4. The essential feature of a lease contract is that it gives one party (the lessee) the right to use for a specified period an item[2] (such as property, plant or equipment) of the lessor. (The lessor may not own the item, but rather may have rights to it that permit the lessor to lease it to a third party). This right of use may be largely unfettered in that the lessee is able to use the item almost as though it owned the item; or there may be restrictions on the right of use (for example, the lease of retail shop premises may specify the type of goods that may be sold).

5. In exchange for this right, the lessee assumes the obligation to make specified payments, usually over the lease term. In addition, the agreement is likely to impose a requirement to maintain the item in a satisfactory condition and may require the lessee to return the item at the end of the lease term or otherwise to deal with it on behalf of the lessor.

6. The staff have analysed the promises exchanged and rights and obligations arising in a simple leasing arrangement using the following example:

    A piece of machinery is leased for a fixed term of 5 years; the expected life of the machinery is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machinery at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals

[2] This paper uses the term *asset* to refer solely to an item that is recognised on the balance sheet of the lessor or lessee, and not to the physical item itself.

over the lease term; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

7. In practice, the lessee will be required to return the machinery to the lessor in a specified condition at the end of the lease term. However, the lessee's commitment to maintain the machinery in a specified condition is ignored for the purposes of this simple example. The staff will consider the rights and obligations that arise from this commitment at a later stage.

8. The promises exchanged and the rights and obligations arising in this simple lease are summarised in the following table:

Lessor	**Lessee**
• Obligation to permit use of the machinery during the lease term **(possibly conditional on payments being received)** • Right to receive payments during the lease term **(conditional on allowing lessee to use the machinery)** • Right to return of machinery at end of lease term • Right to the economic benefits derivable from use of the machinery in the period after the lease term (this right does not arise out of the lease contract itself but is included in this table for completeness)	• Right to use machinery for the lease term – the right to the economic benefits derivable from use of the machinery **(possibly conditional on payments being made)** • Obligation to make specified payments over the lease term **(conditional on being allowed to used the machinery)** • Obligation to return the machinery at the end of the lease term

Question for the working group members

9. At the working group meeting, the staff will seek feedback from the working group members on the following question:

- **Has the staff correctly identified the promises exchanged and the rights and obligations arising in this simple lease contract?**

Application of asset and liability definitions

10. Paper 4 provides background information for working group members on both the existing asset and liability definitions and the working definitions that have been proposed by the conceptual framework team.

11. The following sections of this paper apply both the current and the proposed definitions of assets and liabilities to the rights and obligations identified above.

12. Although the wording of the current IASB and FASB asset definitions are different, the basic concepts underpinning them are very similar. The IASB framework and CON 6 have the following characteristics of an asset in common:

    - The reporting entity controls the economic benefit or resource;
    - The transaction or event that gives rise to that control is a past event; and
    - Future economic benefits are expected to flow to the entity.

13. Similarly the wording of the liability definitions contain the same basic characteristics:

    - There exists a present obligation;
    - The obligation is expected to result in an outflow of economic benefits;
    - The obligation arises out of a past event.

14. Because of the similarities between the definitions, the staff has used the common characteristics identified above when analysing whether a right or obligation meets the definition of an asset or liability.

9. This paper does not discuss the recognition criteria for assets and liabilities. Under the IASB's Framework and CON 6, an item that meets the definition of an asset or liability is only recognised if it meets certain recognition criteria. In particular, an asset or liability is recognised only if it is capable of being measured reliably. This issue will be discussed when the staff consider measurement.

Application of current asset and liability definitions

Lessee assets and liabilities

Does the lessee's right to use the item meet the definition of an asset?

15. Under the terms of the lease contract, the lessee obtains the right to use the machinery during the lease term. This right to use the machinery is an economic resource of the entity as the machinery can be used to generate cash inflows or reduce cash outflows.

16. It might be argued that the lessee's right to use the machinery is conditional upon the lessee making payments over the lease term. That is, if the lessee does not make payments as they fall due, there is no right to use the machinery since the lessor will seek to repossess it to recover the amounts owed. If this analysis is accepted, the right to use the machinery for the entire lease term would not meet the definition of an asset, as the past event that would trigger recognition of an asset is the lessee making payments under the lease contract.

17. However, the staff believes that under a non-cancellable lease the right to use the machinery and the obligation to pay for its use should be considered to be unconditional once the machinery has been delivered to the lessee. The lessee has possession of the machinery and no further action is required by the lessor to enable the lessee to use it for the whole of the lease term. That is, the lessee's right to use the item is not dependent on performance by the lessor. The lessee has no contractual right to return the machinery and cease making payments. It is the non-cancellable nature of the lease that gives rise to the unconditional right to use the machinery. Similarly, as long as the lessee continues to meet its obligations under the contract the lessor has no right to demand the return of the machinery.

18. This can be contrasted to a cancellable lease where the obligation to make payments and the right to use the machinery are clearly interdependent, and where at any point in time the lessee has the right to return the machinery and cease making payments to the lessor.

19. Therefore, for a non-cancellable lease:

    a. The right to use the item is an economic resource;

    b. It is controlled by the lessee during the lease term, since the lessor is unable to recover or have access to the resource without consent of the lessee;

    c. The control results from past events – the signing of the lease contract and the delivery of the item by the lessor to the lessee;

    d. Future economic benefits from use of the item during the lease term will flow to the lessee.

20. Accordingly, the lessee's right to use the machinery for the lease term meets the Framework and CON 6 definition of an asset.

Questions for the working group members

21. At the working group meeting, the staff will seek feedback from the working group members on the following questions:

- **Do the working group members agree that under a lease contract the lessee obtains a right to use the leased item that meets the definition of an asset? If not, why not?**
- **What practical issues need to be considered if this asset is to be recognised?**

Does the lessee's obligation to pay rentals meet the definition of a liability?

22. One view is that the lessee's obligation to make payments over the lease term is a conditional obligation. That is, unless the lessor provides the lessee with the item and permits use of it each day of the lease term, the lessee has no obligation to pay for the

right to use the item for that day. An alternative way of describing this would be to say that the lessee has a stand-ready obligation to pay for each day's use of the item, but until it actually is able to use the item for a particular day there is no obligation for that day's rental itself.

23. However, the lessor has no right to cancel the lease, nor the right to regain possession of the item until the end of the lease term. The lessee has no right to terminate the lease prior to the end of the lease and avoid paying rentals. The lessee, therefore, does not have a stand-ready obligation that is conditional on each day's use of the item, but an unconditional obligation to pay the rentals.

24. In summary, for a non-cancellable lease:

    a. The lessee has a present obligation for the lease rentals;

    b. This obligation arises out of past events—the entering into the lease agreement and the delivery of the item from the lessor to the lessee;

    c. The obligation is expected to result in the outflow of resources embodying economic benefits (usually cash).

25. Accordingly, the lessee's obligation to make payments under a non-cancellable lease meets the Framework and CON 6 definition of a liability.

Questions for the working group members

26. At the working group meeting, the staff will seek feedback from the working group members on the following questions:

- **Do the working group members agree that under this simple lease the lessee has an obligation to pay for the leased item that meets the definition of a liability? If not, why not?**
- **What practical issues need to be considered if this liability is to be recognised?**

Is the obligation to return the item at the end of the lease term a liability?

27. The lessee has physical possession of the machinery at the end of the lease term and, therefore, may have an obligation to return the machinery to the lessor at the end of the lease term. This is a present obligation that is established by a past event (the delivery of the machine). Therefore, if this obligation to return the machine will result in an outflow of economic benefits, the obligation will meet the definition of a liability.

28. It might seem that there is a clear outflow of economic benefits at the end of the lease term as the lessee must surrender the physical item (which presumably still has some economic potential).

29. However, the staff believes that there is no outflow of economic benefit from the lessee when it returns the machinery. The lessee has no right to the economic benefit embodied in the machinery after the end of the lease term. The lessee has physical possession of the machinery but no rights to use the machinery once the lease term has expired. The position of the lessee at the end of the lease term can be compared to that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no rights to the economic benefits embodied in that asset.

30. Consequently, the staff believes that the obligation to return the machinery does not result in an outflow of economic benefits from the lessee and does not meet the definition of a liability.

Question for the working group members

31. At the working group meeting, the staff will seek feedback from the working group members on the following question:

- **Do the working group members agree that under a lease contract the lessee's obligation to return the leased item does not meet the definition of a liability? If not, why not?**

Summary

32. The following tables summarise the lessee's rights and obligations under the lease contract after the delivery of the machinery:

Description of right	Control	Past event	Future economic benefit	Asset?
Right to use machinery during the lease term	Legally enforceable right to use the machinery	The signing of the lease contract and delivery is the past event	Yes	Yes

Description of Obligation	Present obligation	Past event	Outflow of economic benefits	Liability?
Obligation to make specified payments over the lease term	Obligation established by the lease contract	Delivery of machinery	Cash	Yes
Obligation to return the machinery at the end of the lease term	Obligation established by the lease contract	Delivery of machinery	No, as lessee has no right to economic benefits from the machinery after the end of the lease term.	No

Lessor assets and liabilities

33. The lessor's right to receive payments over the lease term is not conditional upon the lessor granting the lessee the right to use the machinery each day of the lease. Under a non-cancellable lease the right is unconditional once the machinery has been delivered. The lessee can only avoid making payments under the lease contract if the lessor, in some way, breaks the terms of the lease contract.

34. Upon signing the lease contract the lessor obtains a conditional right to receive payments over the lease term (the right is conditional upon the lessor delivering the leased item to the lessee). Once the machinery has been delivered to the lessee, the right to receive payment becomes unconditional and is controlled by the lessor (it is legally enforceable). The unconditional right arises out of a past event (the delivery of the machinery) and gives rise to future economic benefit. Consequently, this right meets the definition of an asset.

35. In effect, the lessor has exchanged some of its ownership rights over the machinery (its right to use the item during the lease term) for a receivable from the lessee. Whether this exchange gives rise to revenue for the lessor will be discussed at a later stage in the project.

36. The lessor's right to have the machinery returned at the end of the lease does not in itself meet the definition of an asset. The right to have the machinery returned does not result in an inflow of economic benefits. It is the lessor's right to the economic benefits deliverable from use of the machinery after the end of the lease that gives rise to an inflow of economic benefits. Again, this situation can be compared to the rights of an entity that has transferred assets to an asset custodian whilst retaining control and economic benefit over that asset.

37. The lessor's right to the economic benefits deliverable from the use of the machinery in the period after the lease term (the residual rights) does not arise from the lease contract. However, the residual rights are considered here for completeness. These rights meet the definition of an asset. Control of the residual rights is established through the lessor's legal rights over the machinery. These rights may be contractual rights (if the lessor is itself a lessee of the machinery) or ownership rights. The past event giving rise to these rights was the original acquisition of the machinery. Future economic benefits will flow to the lessor generally through sale or re-lease of the machinery after the end of the lease term.

38. The lessor's only obligation after delivery of the machinery is to permit the use of the machinery by the lessee over the lease term. It can be argued that the existence of this obligation means that the lessor does not have an unconditional right to receive payments over the lease term. However, the staff believes that the once the machinery is delivered to the lessee the lessor has performed its obligation under the lease. Consequently, this obligation does not meet the definition of a liability as it does not result in a future outflow of economic benefits. The outflow of economic benefits has already taken place (that is, the machinery has been delivered).

39. The following tables summarise the lessor's rights and obligations post delivery:

Description of right	Control	Past event	Future economic benefit	Asset?
Right to receive payments during the lease term	Legally enforceable right to receive payments	Signing of lease contract and delivery of machinery	Cash inflows	Yes
Right to return of machinery at the end of the lease	Legally enforceable right to have machinery returned	Signing of lease contract and delivery of machinery	No	No
Right to the economic benefits deliverable from the use of the machinery in the period after the lease term (residual rights) – considered here for completeness	Control is established through original acquisition of rights over the machinery	Original acquisition of rights over the machinery	Yes	Yes

Description of Obligation	Present obligation	Past event	Outflow of economic benefits	Liability?
Obligation to permit the use of the machinery during the lease term	Obligation is established on signing contract	Signing of the lease contract	There is no future outflow of economic benefit.	No

Questions for the working group members

40. At the working group meeting, the staff will seek feedback from the working group members on the following questions:

- **Do the working group members agree that the lessor's obligation to permit the use of the machinery by the lessee does not meet the definition of a liability? If not, why not?**
- **Are there any other lessor obligations that the staff should consider?**

Application of conceptual framework project draft asset and liability definitions

41. The proposed new definitions (described in paper 4) do not fundamentally change the concept of assets and liabilities. Rather they attempt to more clearly express the

existing concept and, therefore, provide a more disciplined means for analysing whether particular items meet the definitions.

42. An economic resource is something that is capable of producing future economic benefits, not the benefits themselves. In the case of a lessee, the promise is the future use of the leased item – but it is the present promise, not the future use, that comprises the economic resource. That promise, coupled with the lessee's right to it, meets the definition of an asset.

43. Similarly, an economic burden is something that is capable of requiring the sacrifice of economic resources. In the case of a lessee, the economic burden is the present promise to make future payments, not the payments themselves. That promise, coupled with the lessee's obligation for it, meets the definition of a liability.

Lessee assets and liabilities

44. The following tables apply the working definitions of an asset and liability to the lessee's rights and obligations under the lease contract after the delivery of the machinery:

Terms of lease contract	**Economic resource**	**Rights or privileged access to resource**	**Exists at Financial statements date?**	**Asset under working definitions?**
Right to use machinery during the lease term	Lessor's promise to permit use of machinery	Contractual right	Yes	Yes

Terms of lease contract	**Economic burden**	**Obligation for burden**	**Exists at Financial statements date?**	**Liability under working definitions?**
Obligation to make specified payments over the lease term	Lessee's promise to pay cash	Contractual obligation	Yes	Yes
Obligation to return the machinery at the end of the lease term	The promise to return the machinery is not an economic burden as the machinery is not an economic resource of the lessee	No	No	No

45. Thus, the analysis of the terms of the lease contract results in similar assets and liabilities being identified under the working definition as under the existing definitions.

Lessor assets and liabilities

46. The following tables apply the working definitions of an asset and liability to the terms of the lease contract as they pertain to the lessor after the delivery of the machinery:

Terms of the lease contract	Economic resource	Rights or privileged access to resource	Exists at Financial statements date?	Asset under working definitions?
Right to receive payments during the lease term	Lessee promise to pay cash	Contractual rights	Yes	Yes
Right to return of machinery at the end of the lease	The right of return is not an economic resource. It is only valuable in combination with the residual rights (see below).	Contractual rights	Yes	No
Right to the economic benefits deliverable from the use of the machinery in the period after the lease term (residual rights)	Machinery	Ownership rights	Yes	Yes

Terms of the lease contract	Economic burden	Obligation for burden	Exists at Financial statements date?	Liability under working definitions?
Obligation to permit the use of the machinery during the lease term	Promise to permit use of machinery	No obligation exists as this is fulfilled when the machinery is delivered	No	No

47. Thus, the analysis of the terms of the lease contract pertaining to the lessor result in similar assets and liabilities being identified under the working definition as under the existing definitions.