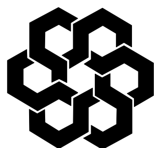

International
Accounting Standards
Board

Financial Accounting
Standards Board

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: **INITIAL RECOGNITION OF ASSETS AND LIABILITIES IN LEASE CONTRACTS (Agenda Paper 8)**

PURPOSE

1. The staff is analyzing various examples of lease contracts in terms of (a) the nature of the promises exchanged in the lease contract and (b) whether those promises and the related rights and obligations of the lessee and lessor give rise to assets and liabilities (refer to agenda paper 5). As different assets and liabilities arise in a lease contract at different times, the purpose of this paper is to discuss the timing of *when* initial recognition of assets and liabilities that arise in a lease contract should take place and what those assets and liabilities are.

Question for the working group members

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

- **When should assets and liabilities identified in a lease contract be initially recognized in the financial statements? Upon (a) the signing of the contract, (b) the delivery of the property, or (c) some other event (and if so, what other event)?**
- **What is the nature of those assets and liabilities?**

Background

3. In order to analyze when assets and liabilities that arise in a lease contract should be initially recognized in the financial statements, the staff has considered the existing recognition guidance found in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, (CON 5) and the IASB *Framework for the Preparation and Presentation of Financial Statements* (Framework). In addition, the staff also has considered the current authoritative literature found in FASB Statement No. 13, *Accounting for Leases*, and IAS 17, *Leases*.

Concepts Statement 5 and Framework

4. Paragraph 63 of CON 5 states that, to be recognized, an item and information about that item should meet four fundamental recognition criteria, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:

   a. *Definitions*–The item meets the definition of an element of financial statements.

   b. *Measurability*–It has a relevant attribute measurable with sufficient reliability.

   c. *Relevance*–The information about the item is capable of making a difference in user decisions.

   d. *Reliability*–The information is representationally faithful, verifiable, and neutral.

5. The Framework was approved by the IASC Board in 1989 and adopted by the IASB in 2001. Paragraph 83 of the Framework states that an item that meets the definition of an element should be recognized if:

   a. It is probable that any future economic benefit associated with the item will flow to or from the entity.

   b. The item has a cost or value that can be measured with reliability.

6. Paragraphs 89 and 90 of the Framework provide specific guidance for the recognition of assets and state the following, respectively:

> An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
>
> An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

7. Paragraph 91 of the Framework provides specific guidance for the recognition of liabilities and states the following:

> A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not

yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

8. The criteria in CON 5 and the Framework for recognizing assets and liabilities will be reconsidered as part of the current joint Conceptual Framework project, but that topic has not yet been addressed. Accordingly, the staff will focus its analysis for recognition at this time on whether an item meets the definition of an asset or a liability (which is a recognition criterion under CON 5 and a precondition of recognition under the Framework). The remaining recognition criteria in CON 5 and the Framework, such as measurement, along with materiality and cost benefit considerations will be considered at a later stage of the project.

Statement 13 and IAS 17

9. Statement 13 was issued in 1976 prior to the development of the Concepts Statements.[1] Statement 13 distinguishes between capital leases and operating leases and states, in paragraph 10, that "the lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value **at the beginning of the lease term** of minimum lease payments during the lease term…" (emphasis added). No assets or liabilities are recognized by lessees for operating leases, and rental charges are typically charged to expense over the lease term as they become payable.

10. Paragraph 5(b) of Statement 13 generally addresses the signing of the contract by defining the *inception of the lease* (as opposed to the beginning of the lease term) as follows:

> The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal

[1] Concepts Statements 1–6 were issued between 1978 and 1985. Concepts Statement 7 was issued in 2000.

provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

11. IAS 17 was first issued in 1982 (before the Framework was issued) and was revised in 1997 and 2003. IAS 17 defines both *inception of the lease* and *commencement of the lease term* in paragraph 4 as follows:

> The *inception of the lease* is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:
>
> (a) a lease is classified as either an operating or a finance lease; and
>
> (b) in the case of a finance lease, the amounts to be recognized at the commencement of the lease term are determined.
>
> The *commencement of the lease term* is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

12. Paragraphs BC16 and BC17 from the basis for conclusions of IAS 17 (revised 2003) state the following:

> The previous version of IAS 17 did not define the commencement of the lease term. It implicitly assumed that commencement (when the lease begins) and inception (when the agreement is entered into) are simultaneous. Some respondents questioned what should happen if there is a time lag between the two dates, particularly if the amounts change–for example, because the asset is under construction and the final cost is not known at inception. The Standard now specifies that recognition takes place at commencement, based on values

measured at inception. However, if the lease is adjusted for changes in the lessor's costs between the inception of the lease and the commencement of the lease term, the effect of any such changes is deemed to have taken place at inception. These revisions are consistent with generally accepted accounting principles in Australia, Canada and the United States, and are consistent with the present accounting treatment of most ordinary purchases and sales.

In agreeing on this treatment, the Board noted that measurement at commencement would have been more satisfactory in principle. However, this cannot be done properly within the framework of IAS 17 because the Standard generally requires a finance lease receivable or payable to be recognised at an amount based on the fair value of the asset, which is inappropriate at any date after inception.

13. The current accounting literature distinguishes between the inception of the lease and the commencement of the lease term. The inception of the lease is the date at which an entity determines the lease classification (operating or financing), which may not be the same date as the commencement of the lease term. Under current practice, the lease term begins (and initial recognition occurs, for both the lessee and the lessor) when the lessee takes possession or is given control of the leased property by the lessor.

Related projects

14. The Boards have discussed contractual promises in their other agenda projects. For example, in both the joint Conceptual Framework project and the joint Revenue Recognition project the Boards have observed that contractual promises may be:

Conditional–subject to the occurrence of an event that is not certain to occur (such as performance by the counterparty),

Unconditional–only the passage of time is required to make performance due, or

Mature–not subject to any event, including the passage of time

15. The Boards have tentatively concluded that contractual promises that are conditional do not meet the definition of an asset for the promissee or a liability for the promisor because their performance is not presently required. However, promises that are unconditional and mature (i.e., non-conditional) may meet the definition of an asset or a liability.

16. In the IASB's project to amend IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, the Board concluded that liabilities arise only from unconditional (or non-contingent) obligations. That is, something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability.

17. In the project that resulted in issuing FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, (FIN 45), concluded that the issuance of a guarantee obligates the guarantor in two respects: (a) the guarantor undertakes a noncontingent obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur, and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur. Under FIN 45, a liability is recognized immediately for the noncontingent obligation to stand ready.

18. In the Revenue Recognition project, the issue has arisen of whether a "price guarantee" that is inherently provided by a seller in signing a fixed-price contract represents a stand-ready obligation that may need to be recognized. It appears that the guarantees addressed in FIN 45 are different than those being contemplated in the

Revenue Recognition project as there, effectively, is no triggering event analogous to those within the scope of FIN 45 (such as default on a loan), but rather a notion that the buyer/lessee will purchase/lease an item at a specified date. In the context of a lease contract, because the lessor has agreed to provide the leased item to the lessee at a specified price at a future date, there could (and probably will) be fluctuations in the price/rate of the item subsequent to the signing of the contract.

Analysis

19. Agenda paper 4 describes the Boards' existing definitions and working definitions of assets and liabilities, and agenda paper 5 identifies assets and liabilities arising in a simple lease contract upon delivery of the leased item. The focus of this analysis relates to the timing of *when* assets and liabilities arise in a lease contract and should be initially recognized in the financial statements. The issue is whether assets and liabilities that arise in a lease contract should be initially recognized upon (a) the signing of the contract, (b) the delivery of the property, or (c) some other event (and if so, what other event), and what is the nature of those assets and liabilities.

20. As noted above, the staff will focus its analysis of initial recognition on whether an item meets the definition of an asset or a liability. Since leases are contracts, the staff will use the working definitions because they clarify aspects of the existing definitions, particularly with respect to assets and liabilities arising out of contracts. The analysis will consider the same simple non-cancellable lease contract described in paragraph 6 of agenda paper 5, and assumes that it is a fixed-rate lease.

Signing of the lease contract

21. The first date on which assets and liabilities might arise is when the lease contract is signed. A contract is, by definition, an exchange of promises, and such an exchange of promises occurs between the lessee and the lessor upon signing the lease contract. The question is whether those promises give rise to assets and liabilities.

22. In a lease contract, two stated promised are exchanged. One is the lessor's promise to deliver the specified property to the lessee and give the lessee the right to use that

property over the lease term. The other is the lessee's promise to make lease payments to the lessor and gives the lessor the right to collect those payments.

23. One way of analyzing whether assets or liabilities have arisen upon signing the lease is by considering the nature of the promises exchanged, that is, whether the promises are conditional or nonconditional at that date. Under the working definitions of an asset and liability, nonconditional contractual promises can be economic resources to the promisee, and thereby an asset to the promissee, or economic burdens to the promisor, and thereby a liability to the promisor. However, contractual promises that are conditional would not meet those definitions because their performance is not presently required.

24. A lease contract binds the lessor to deliver the leased item and the lessee to make lease payments in exchange for the use of the leased item. In the simple lease example, the lessor performs first by delivering the leased item. Accordingly, the lessor's stated promise is unconditional at the date the lease contract is signed, and therefore would meet the definition of a liability for the lessor and an asset for the lessee. Since the lessee is not required to perform until the lessor performs, the lessee's stated promise is conditional upon delivery of the leased item, and therefore would not meet the definition of a liability for the lessee or the definition of an asset for the lessor. However, although the lessee's promise of performance is conditional upon the lessor's performance, the lessee also is obligated by the contract to stand ready to perform, that is, to accept delivery of the specified property on the date that the lessor is required to deliver it. That "stand ready" obligation is not subject to the occurrence of an event that is not certain to occur, and hence is unconditional. As such, that obligation would meet the liability definition for the lessee and the asset definition for the lessor.

25. Another issue at the signing of the contract is that implicit price guarantees may arise. That is, it could be argued that the lessor has guaranteed the lessee against future increases in lease rates, and the lessee has guaranteed the lessor against future decreases in lease rates. Assuming that lease rates changed after the signing of the

contract, the lessor and the lessee are still obligated to honor the terms of the contract. Therefore, unless both the lessee and the lessor negotiate and agree to amend the terms of the lease contract, the only actions each party could take to not perform under the original contract is to breach the contract or negotiate a settlement. In those cases, a negotiated settlement or monetary damages would reflect the effects of the price guarantee.

26. There are some other considerations with regard to initial recognition on signing the contract. For example, the recognition criteria in CON 5 and the Framework also concern measurement. Therefore, consideration must be given to how any assets and liabilities that arise on signing and are recognized then should be measured

27. The signing of a lease contract at specified terms is akin to a "normal purchase and sale". When considering how a "price protection guarantee" would be recognized and measured, one possibility would be to record such guarantees at fair value consistent with the accounting for derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. However, normal purchases and sales transactions are explicitly scoped out of Statement 133 (paragraph 10).

28. This analysis can then be extended to the period after signing the lease. Because lease rates are likely to change, would the assets and liabilities arising from the lease contract be measured at fair value over the entire lease term?

29. The staff acknowledges that there may be significant practical issues associated with recognizing an asset or liability upon signing a lease contract. For example, measuring such assets and liabilities may be difficult. Moreover, if the lease rate is the market rate on the date of signing, the value of that price protection may be immaterial (although it could become material later on).

Delivery of the asset to the lessee (performance occurs)

30. Assets and liabilities presently are not recognized when the lease contract is signed. One argument for not recognizing assets and liabilities upon signing a lease is

because those assets and liabilities are equal and offsetting at that date, especially if the lease rate is set at the then-current market rate.

31. Another argument for not recognizing assets and liabilities when the lease contract is signed is because executory contracts generally are not recognized. According to *Black's Law Dictionary* (Eighth edition), an *executory contract* is:

> A contract that remains wholly unperformed or for which there remains something still to be done on both sides, often as a component of a larger transaction and sometimes memorialized by an informal letter agreement, by a memorandum, or by oral agreement.

Therefore, until either the lessee or the lessor has performed any of their stated promises under the lease contract, the lease contract is executory.

32. Once either the lessee or lessor has performed, the contract is no longer executory. Under current lease accounting literature, a finance lease is recognized upon performance. However, even after delivery has occurred and the contract is no longer executory, operating leases are not recognized.

33. For a lessor, arguably the most substantial act of performance is delivering the leased item to the lessee. Thus, once the lessor has delivered the leased item to the lessee, the lessor's performance under the lease has been substantially completed and the lessor now has an unconditional right to collect lease payments. Similarly, once the leased item has been delivered and the lessee is able to begin using it, the lessee has an unconditional obligation to make lease payments. The above analysis assumes that delivery of the leased item occurs before payment. If, alternatively, the lessee performs first by making lease payments, the lessee has a nonconditional obligation to receive the leased item and the lessor has a nonconditional obligation to deliver the leased item.

Conclusion

34. Contractual promises must meet the definitions of assets and liabilities before they can be recognized in the financial statements. To meet the current working definitions of assets and liabilities, those promises must be nonconditional. Therefore, consideration must be given as to when a promise becomes nonconditional in a lease contract in order for an asset or liability to be initially recognized in the financial statements.

35. Meeting the definitions, therefore, is a necessary condition for recognizing assets and liabilities arising out of lease contracts. However, it is not a sufficient condition. The other recognition criteria in the Framework and also CON 5 must be considered (for example: measurability, relevance, and reliability) as well as cost benefit considerations and materiality.

36. The staff is interested in obtaining from working group members their views on when and how assets and liabilities that arise in lease contracts should be recognized initially—upon signing the contract, upon delivering the equipment, or upon some other event?