



**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: **IDENTIFICATION OF ASSETS AND LIABILITIES ARISING IN A
LEASE WITH A LESSEE OPTION TO RENEW (Agenda Paper 9)**

Introduction

1. The purpose of this paper is to analyse a lease arrangement that provides the lessee with an option to extend the lease. This paper builds upon the analysis of the simple lease in paper 5.
2. This paper first identifies the rights and obligations of the lessee and lessor that arise as a result of the exchange of promises in a lease contract that incorporates a lessee option to renew or extend the lease term. It then considers which of the additional rights and obligations identified 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.

3. As with paper 5, this paper does not consider any rights or obligations that might have arisen before the leased item has been delivered to the lessee. In addition, this paper does not address the measurement of the assets and liabilities identified.

Promises exchanged and rights and obligations arising in a lease incorporating a lessee option to renew

4. Lease contracts will often grant to a lessee the right (but not the obligation) to extend the lease term beyond the initial lease period (“primary period”). The rental in this secondary period may be a fixed amount specified in the original lease contract or a fair market rent at the beginning of the secondary period.

5. The staff have analysed a lease of this type using the following example:

A piece of machinery is leased for a fixed, non-cancellable term of three years; the expected economic life of the machinery is ten years. At the end of the first 3 years (the primary period), the lessee has the right to extend the lease for an additional 2 years (the secondary period). Lease payments are due at regular intervals over the primary period and, if the lessee exercises the option, over the secondary period; amounts payable in both the primary and secondary periods are fixed in the original lease contract.

6. The rights and obligations arising in a lease of this type are analysed below:

| Lessor | Lessee |
|---|--|
| Unconditional | |
| <ul style="list-style-type: none"> • Obligation to permit use of the machinery during the primary period • Right to receive payments during the primary period—includes amount payable for option premium, though not usually specified as such • Right to the economic benefits derivable from use of the machinery in the period after the secondary period (this right does not arise from the lease contract but is included for completeness) • Obligation to extend lease if lessee exercises option. | <ul style="list-style-type: none"> • Right to use machinery for the primary period—the right to the economic benefits derivable from use of the machinery • Obligation to make specified payments over the primary period—includes amount payable for option premium, though not usually specified as such • Right to choose to extend lease. |

| Conditional on lessee not exercising option to extend: | |
|--|---|
| <ul style="list-style-type: none"> • Right to return of machinery at the end of the primary period • Right to the economic benefits derivable from use of the machinery in the secondary period. | <ul style="list-style-type: none"> • Obligation to return the machinery at the end of the primary period. |
| Conditional on lessee exercising option to extend: | |
| <ul style="list-style-type: none"> • Obligation to permit use of the machinery during the secondary period • Right to receive payments during the secondary period • Right to return of machinery at end of secondary period. | <ul style="list-style-type: none"> • Right to use machinery for the secondary period—the right to the economic benefits derivable from use of the machinery • Obligation to make specified payments over the secondary period • Obligation to return the machinery at the end of the secondary period. |

Question for the working group members

7. 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 lease contract?**

Application of asset and liability definitions

8. 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.

Application of current asset and liability definitions

Lessee assets and liabilities

9. As with the simple lease, the staff believes that the lessee’s unconditional right to use the machinery in the primary period meets the definition of an asset.

10. The lessee’s right to use the machinery in the secondary period is a conditional right. That is, the right is conditional upon exercise of the lessee’s option. Unless and until that option is exercised, this right does not meet the definition of an asset.

11. However, associated with this conditional right is an unconditional right. The lessee has an unconditional right to call for the use of the machinery during the secondary period. This right is controlled by the lessee, arises from a past event (the signing of the lease contract) and gives rise to future economic benefit (the right to use the machinery in the secondary period). Although at any particular point in time this option may be out of the money (that is, the cost of exercising the option may exceed the benefits arising from the right of use in the secondary period), it will, until the exercise date, have time value and hence could give rise to an inflow of economic benefit. Consequently, the lessee’s unconditional right to call for the use of the machinery in the secondary period meets the definition of an asset.

12. This analysis does not alter with the likelihood of the option being exercised. Even if the rentals in the secondary period are low so that the lessee is very likely to exercise the option, the right to use the machinery and the obligation to pay rentals for the secondary period are still conditional until the option is actually exercised (although such an option will be more valuable than one where the rentals are higher).

13. The lessee’s assets arising under this lease contract after the delivery of the machinery can be summarised as follows:

| Description of right | Control | Past event | Future economic benefit | Asset? |
|--|--|---|-------------------------|--------|
| Unconditional right to use machinery during the primary period | Legally enforceable right to use the machinery during the primary period | The signing of the lease contract and delivery is the past event | Yes | Yes |
| Unconditional right to call for the use of machinery during the secondary period | Legally enforceable right to call for the use of the machinery during the secondary period | The signing of the lease contract and delivery is the past event | Yes | Yes |
| Conditional right to use the machinery during the secondary period | The lessee controls the right to use the asset during the secondary period | There is no past event. Right is conditional on exercise of the option. | Yes | No |

14. As with the simple lease, the lessee has an unconditional obligation to make payments over the primary period that the staff believes meets the definition of a liability.

However, as discussed in paper 5, the lessee's obligation to return the machinery at the end of the lease term (whether at the end of the primary period or the secondary period) does not meet the definition of a liability because the lessee is not required to sacrifice any of its economic benefits.

15. The lessee also has a conditional obligation to make payments over the secondary period. However, this obligation does not meet the definition of a liability as the outflow of economic benefit can be avoided if the lessee does not exercise its right to extend the lease.

16. The lessee's liabilities arising under this lease contract after the delivery of the machinery can be summarised as follows:

| Description of Obligation | Present obligation | Outflow of economic benefits | Past event | Liability? |
|---|--|---|-----------------------|------------|
| Unconditional obligation to make specified payments over the primary period | Obligation established by the lease contract | Cash | Delivery of machinery | Yes |
| Conditional obligation to return the machinery at the end of the primary period | No present obligation as it is conditional on expiration of the option unexercised | Yes | Delivery of machine | No |
| Conditional obligation to make specified payments over the secondary period | No present obligation as it is conditional on exercise of the option | Outflow of economic benefit can be avoided if the lessee does not exercise its option to extend the lease | No past event | No |
| Conditional obligation to return the machinery at the end of the secondary period | No present obligation as it is conditional on exercise of the option | No | No past event | No |

Questions for the working group members

17. 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 lessee's right to call for the use of the machinery in the secondary period meets the definition of an asset? If not, why not?**

- **What practical issues need to be considered if this asset is to be recognised?**
- **Do the working group members agree that the lessee’s conditional obligation to make payments over the secondary period does not meet the definition of a liability? If not, why not?**

Lessor assets and liabilities

18. The following table summarises the lessor’s rights under a lease with a lessee option and applies the asset definition criteria to those rights.

| Description of right | Control | Past event | Future economic benefit | Asset? |
|---|--|---|-------------------------|--------|
| Unconditional right to receive payments during the primary period | Legally enforceable right to receive payments | Signing of contract and delivery of machinery | Cash | Yes |
| Unconditional right to the economic benefits deliverable from the use of the machinery in the period after the secondary period (residual rights) | Legal rights over machinery | Original acquisition of rights over the machinery | Yes | Yes |
| Conditional right to return of machinery at end of primary period | The lessor has no control over the return of the machinery at the end of the primary period | Signing of contract and delivery of machinery | No | No |
| Either Right to the economic benefits derivable from use of the machinery in the secondary period Or Conditional right to receive payments during the secondary period | The lessor controls: <ul style="list-style-type: none"> • The right to economic benefits deliverable from the machinery in the secondary period if the lessee does not exercise its option to extend the lease; or • The right to receive payments during the secondary period if the lessee exercises its option to extend the lease. | Original acquisition of rights over the machinery | Yes | Yes |
| | | Signing of contract and delivery of machinery | Yes | |
| Conditional right to return of machinery at end of secondary period | The lessor has no control over whether lessee exercises its option | Signing of contract and delivery of machinery | No | No |

19. The lessor’s unconditional contractual right to receive payments during the primary period and its right to the economic benefits deliverable from the use of the machinery

in the period after the secondary period clearly meet the definition of an asset. They are similar to the assets identified for the simple lease. The lessor's right to have the machinery returned at the end of the lease term (whether at the end of the primary or secondary period) does not meet the definition of an asset because the lessor already has the right to the economic benefits.

20. The rights to the economic benefits derivable from use of the machinery in the secondary period and the right to receive payments in the secondary period are interdependent. The lessor either has an ownership right to the use of the machinery in the secondary period or a contractual right to receive lease payments during the secondary period. If the lessee exercises its option to extend the lease, the lessor will obtain an unconditional contractual right to receive lease payments instead of having the ownership right to use the machinery. In either case, the lessor has an asset, so when considered together this bundle of rights meets the definition of an asset.
21. As for the simple lease, the lessor's obligation to permit the use of the machinery by the lessee (either during the primary or the secondary period) does not meet the definition of a liability as it does not result in a future outflow of economic benefit.
22. However, the lessor does have an unconditional stand-ready obligation. If the lessee exercises its option to extend the lease, the lessor must grant the lessor a right to use the machinery during the secondary period in return for rental payments. The lessee, seemingly, will only exercise this option if it is in-the-money.¹ That is, the fair value of the right to use the asset in the secondary period is in excess of the fair value of the rental payments. Consequently, the lessor's unconditional obligation to stand ready to grant a right of use to the lessee in the secondary period meets the definition of a liability.

Questions for the working group members

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

¹ In practice, there may be situations where the lessee will choose to exercise its option when it is out-of-the-money. These situations will be considered in a later paper.

- **Do the working group members agree that the lessor’s unconditional obligation to stand ready to grant a right of use to the lessee in the secondary period meets the definition of a liability? If not, why not?**
- **What practical issues need to be considered if this liability is to be recognised?**

Application of Conceptual Framework project’s working asset and liability definitions

24. As discussed in paper 5, the new definitions do not fundamentally change the concept of asset and liability. Consequently, the assets and liabilities identified using the revised definitions are the same as those identified using the current definitions.

Lessee rights and obligations

25. 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 statement date? | Asset under working definitions? |
|--|---|--|--|---|
| Unconditional right to use machinery during the primary period | Lessor’s promise to permit use of machinery in primary period | Contractual right | Yes | Yes |
| Unconditional right to call for the use of machinery during the secondary period | Promise of right to call for use of machinery | Contractual right | Yes | Yes |
| Conditional right to use the machinery during the secondary period | Lessor’s promise to permit use of machinery in the secondary period | Contractual right | No—right is conditional | No |

| Terms of lease contract | Economic burden | Obligated for burden | Exists at financial statement date? | Liability under working definitions? |
|---|--|-----------------------------|--|---|
| Unconditional obligation to make specified payments over the primary period | Lessee's promise to pay cash | Contractual obligation | Yes | Yes |
| Conditional obligation to return the machinery at the end of the primary period | The promise to return the machinery is not an economic burden as the machinery is not an economic resource of the lessee | Contractual obligation | No—Obligation is conditional on lessee not exercising option | No |
| Conditional obligation to make specified payments over the secondary period | Promise to pay cash over the secondary period | Contractual obligation | No—Obligation is conditional on exercise of option | No |
| Conditional obligation to return the machinery at the end of the secondary period | The promise to return the machinery is not an economic burden as the machinery is not an economic resource of the lessee | Contractual obligation | No—Obligation is conditional on exercise of option | No |

Lessor rights and obligations

26. The following tables apply the working definitions of an asset and liability to the lessor's rights and obligations under the lease contract:

| Terms of lease contract | Economic resource | Rights or privileged access to resource | Exists at financial statement date? | Asset under working definitions? |
|---|---|---|---|----------------------------------|
| Unconditional right to receive payments during the primary period | Lessee promise to pay cash during primary period | Contractual right | Yes | Yes |
| Unconditional right to the economic benefits deliverable from the use of the machinery in the period after the secondary period (residual rights) | Machinery | Ownership rights | Yes | Yes |
| Conditional right to return of machinery at end of primary period | The right of return is not an economic resource. It is only valuable in combination with the residual rights (see below). | Contractual right | No—Right is conditional on option not being exercised | No |
| Either Right to the economic benefits derivable from use of the machinery in the secondary period | Machinery | Ownership right | Yes | Yes |
| Or Right to receive payments during the secondary period | Lessee promise to pay cash during the secondary period | Contractual right | | |
| Conditional right to return of machinery at end of secondary period | The right of return is not an economic resource. It is only valuable in combination with the residual rights (see below). | Contractual right | No—Right is conditional on option being exercised | No |

| Terms of lease contract | Economic burden | Obligated for burden | Exists at financial statement date? | Liability under working definitions? |
|---|---|--|--|---|
| Unconditional obligation to permit the use of the machinery during the primary period | Promise to permit use of machinery | No obligation exists as it is fulfilled upon delivery of machinery | No | No |
| Unconditional stand ready obligation to permit use during the secondary period | Promise to stand ready to permit use of machinery in secondary period | Contractual obligation | Yes | Yes |
| Conditional obligation to permit right of use in secondary period | Promise to permit right of use in the secondary period | Contractual obligation | No—obligation is conditional | No |