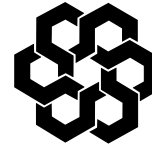

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**19 June 2007, London**
Project:	**Leases**
Subject:	**Initial recognition of assets and liabilities in lease contracts (Agenda paper 4C)**

Purpose

1. The purpose of this paper is to analyze alternative approaches for the timing of **when** initial recognition of assets and liabilities that arise in a simple lease contract should take place and what those assets and liabilities are. The simple lease contract is the same as the one described in IASB Agenda Paper 12A (March 2007 Board Meeting)/FASB Memo #2 (March 21, 2007 Board Meeting).

2. The paper first discusses as background information (a) initial recognition criteria under current GAAP and (b) related projects on the Boards' agendas. Next, the paper identifies and analyzes (a) the assets and liabilities that arise upon the signing of a lease contract (assuming the lessor delivers/provides access to the leased item first), (b) the assets and liabilities that arise upon the signing of a lease contract (assuming the lessee makes payments first), and (c) the assets and liabilities that arise upon access to/delivery of the leased item to the lessee. The staff then presents reasons for

not recognizing assets and liabilities arising in a lease contract upon the signing of the lease contract. Finally, the staff provides its recommendation and asks the Boards for their views.

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).

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. 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. Paragraph 90 of the Framework provide specific guidance for the recognition of assets and states the following:

> 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, at this time the staff will focus its recognition analysis 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, the IASB's probability criterion, along with materiality and cost benefit considerations, will be considered at a later stage of the project. Measurement considerations are being presented to the Board in a separate paper; therefore, initial recognition as it relates to measurement will need to be considered further once preliminary Board member views are obtained.

Related Projects

9. Lease contracts are contractual promises, and 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:

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

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

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

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

11. The IASB's project to amend IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, concluded that an obligation that is a liability 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. Liabilities for which the amount that will be required in settlement is contingent on the occurrence or non-occurrence of a future event are sometimes referred to as "stand-ready" obligations. This is because the entity has an unconditional obligation to stand ready to fulfill the conditional obligation *if* the uncertain future event occurs (or fails to occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits.

12. In the project that resulted in the issuance of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, (FIN 45), the FASB 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 at the date the guarantee is effective for the noncontingent obligation to stand ready.

13. 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, effectively, there 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. Under current GAAP, normal purchases and sales, including executed lease contracts, are not accounted for as derivatives.

Introduction

14. In prior Board papers, the staff has focused on the identification of assets and liabilities arising subsequent to the signing of the lease contract and assumed for purposes of those papers that recognition occurred upon delivery (or when the lessee is given access to the leased item). Those prior analyses did not consider the timing of when any assets and liabilities may have arisen from the contract. The focus of this analysis relates to the timing of **when** assets and liabilities arise in a lease contract, the nature of those assets and liabilities, and when those assets and liabilities 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/when the lessee obtains access to the leased item, or (c) some other event (and if so, what other event). The staff have identified and analyzed two critical points for recognition of assets and liabilities that arise in a lease contract. However, Board members could decide that

there are other points to consider such as at the negotiation stage, upon asset construction, or when payments are received.

15. The staff will focus its analysis of initial recognition using the same simplified lease contract discussed in prior memos, as follows:

An item is leased for a fixed term of 5 years; the expected life of the item is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the item at the end of the term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the item has been delivered; these are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other arrangements are entered into.

Identification of Assets and Liabilities upon Signing of the Lease Contract (Lessor Delivers Leased Item First)

16. 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.

17. In a lease contract, two sets of promises are exchanged. One is the lessor's promise to make the item specified in the lease contract available to the lessee for its use of that item over the lease term, and the lessee's promise to accept the leased item. The other is the lessee's promise to make lease payments to the lessor over the lease term as specified in the contract.

18. 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 unconditional at that date.

19. 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 described above, the lessor promises to perform first by providing access to 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.

20. The lessee has made a related promise to accept delivery of the item. 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 an unconditional obligation to stand ready (accept delivery) and to fulfill the conditional obligation (making payments) after the lessor grants access to the leased item. As such, that stand-ready obligation would meet the liability definition for the lessee and the asset definition for the lessor.

21. There is also the lessee's promise to make the required payments over the lease term. Since, in our example, 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.

22. A summary of the conditional and unconditional nature of the promises exchanged upon contract signing are as follows:

Promise 1—Promise by lessor to deliver/make available leased asset			
Lessor:	Obligation to deliver	Unconditional	Liability
Lessee:	Right to lessor's promise (to receive leased asset)	Unconditional	Asset
Promise2—Promise by lessee to make lease payments			
Lessee:	Promise to stand ready to accept delivery	Unconditional	Liability
	Promise to pay	Conditional	(No liability because conditional)
Lessor:	Right to lessee's promise (of accepting delivery)	Unconditional	Asset
	Right to lessee's promise (to receive payments)	Conditional	(No asset because conditional)

Analysis

23. One way to explain the explicit unconditional promise for the lessor to deliver the leased item (liability) and the implicit unconditional promise for the lessee to stand ready to accept delivery of the leased item (asset) is by viewing them as having effectively issued put and call options. The call option held by the lessee that was written by the lessor allows the lessee to obtain (call) the leased item at a future date. The put option held by the lessor that was written by the lessee allows the lessor to deliver (put) the leased item to the lessee at a fixed price at a future date. It is the interaction between the put and the call that makes delivery of the item contractually required.

24. A second way to explain the explicit unconditional promise for the lessor to deliver the leased item (liability) and the implicit unconditional promise for the lessee to stand ready to accept delivery of the leased item (asset) is by viewing them as having effectively conveyed price guarantees. 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 change 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.

Identification of Assets and Liabilities upon Signing of the Lease Contract (Lessee Makes Payments First)

25. If the staff were to consider a different lease example, where the lessee must perform first by making a lease payment, upon signing the contract the lessee has an unconditional obligation for that payment and the lessor has an unconditional right to it. Thus, the lessee has a liability and the lessor has an asset. In addition, the lessee has a conditional right to delivery and use of the leased item and the lessor has a conditional obligation to deliver the leased item once payment has been received, but that right and obligation do not meet the asset or liability definitions. However, the lessor has a related unconditional obligation to stand ready to deliver the leased item and the lessee has a corresponding right, which gives rise to a liability for the lessor and an asset for the lessee. A summary of the assets and liabilities that arise in this scenario is described in the table below:

Promise 1—Promise by lessee to make a payment			
Lessee:	Obligation to make a payment	Unconditional	Liability
Lessor:	Right to lessor's promise (to accept payment)	Unconditional	Asset
Promise2—Promise by lessor to deliver leased item			
Lessor:	Promise to stand ready to deliver leased item	Unconditional	Liability
	Promise to deliver leased item	Conditional	(No liability because conditional)
Lessee:	Right to lessor's promise (to deliver leased item)	Unconditional	Asset
	Right to lessor's promise (to use leased item)	Conditional	(No asset because conditional)

26. This example demonstrates that, just as there are assets and liabilities that arise upon the signing of the contract when the lessor delivers/provides access to the leased item prior to the lessee making a lease payment, there are also assets and liabilities that arise upon the signing of the contract when the lessee makes the first lease payment prior to delivery/access to the leased item. Although the lessee and the lessor end up with different assets and liabilities under each of these scenarios at the contract signing, the analysis would be the same. In other words, regardless of which party must perform first, similar assets and liabilities arise at the signing of a lease contract.

Identification of Assets and Liabilities upon Access to/Delivery of the Leased Item to the Lessee (Performance Occurs)

27. As analyzed in prior Board papers, once the lease contract has been signed and delivery of the leased item has occurred, the lessee has a right to use the leased item, which meets the definition of an asset, and an obligation to make lease payments over the lease term, which meets the definition of a liability. These rights are explicit in the lease contract and are unconditional. Similarly, the lessor has an unconditional right to receive payments during the lease term, which meets the definition of an asset, and a right to the remaining economic benefits pertaining to the leased item (residual rights that arise out of ownership). An analysis of the assets and liabilities identified upon the lessee receiving access to the leased item (regardless of which party performs first) follows:

Promise 1—Explicit Promise by lessee to make payments			
Lessee:	Explicit obligation to make payments	Unconditional	Liability
	Right to use leased asset	Unconditional	Asset
Lessor:	Right to lessee's promise (to receive payments)	Unconditional	Asset

Reasons for Not Recognizing Assets and Liabilities Prior to Delivery/Access to the Leased Item

28. Assets and liabilities are not presently recognized when the lease contract is signed. One argument for not recognizing assets and liabilities upon signing a lease would be if those assets and liabilities are equal and offsetting at that date, which could be the case if the lease rate is set at the then-current market rate.

29. 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. The Boards have discussed accounting for wholly executory contracts in the revenue recognition project. The Boards have tentatively agreed that a rebuttable presumption is that the unit of account of an executory contract is the contract as a whole, unless the legal remedy of specific performance in the event of breach is a stated contractual requirement or is ordered by a court. However, if the legal remedy in the event of breach is specific performance, the unit of account for an executory contract is the assets and liabilities arising from the unconditional rights and obligations in that contract. That is because in all cases, including breach, the parties to the contract are required to physically settle the contract (a two-way flow of resources).

30. In the event of breach of lease contracts (for example, a breach by the lessee), the legal remedy is generally the payment of monetary damages. Such contracts are net settled in cash with the lessee returning the leased item to the lessor and paying the lessor an amount to make them "whole" and the lessor terminating its claim against the lessee. Since such contracts result in a one-way flow of resources, the unit of account is the contract as a whole, and only a net asset or liability is recognized. Thus, at the date of signing, many lease contracts may not be recognized if the lessee's assets and liabilities are equal in amount, because those amounts may be offset against each other. The staff notes that there could be lease contracts that require specific performance in the event of breach, but expects those situations to be rare.

31. In addition, between contract signing and delivery a lease contract is effectively a forward contract (a contract for delivery of a right to use asset). Under current

GAAP, forward contracts are either treated as derivatives or not recognized at all. Theoretically, it therefore may make sense for the lessee to recognize this forward contract between contract signing and delivery as a derivative. However, the signing of a lease contract at specified terms is akin to a "normal purchase and sale" and normal purchases and sales transactions are explicitly scoped out of Statement 133 (paragraph 10). Paragraph 5 of IAS 39 contains a similar scope exception.

Staff Recommendation

32. Contractual promises must meet the definitions of assets and liabilities before they can be recognized in the financial statements. The staff acknowledges that assets and liabilities arise upon contract signing and that there may be some conceptual basis for recognizing those assets and liabilities at contract signing. However, the staff does not recommend recognizing those assets and liabilities at that time for the reasons discussed in paragraphs 28-31 above. Currently, in GAAP, assets and liabilities are not recognized when the lease contract is signed. If they were recognized at that time, they would be recognized on a net basis (assets and liabilities netted). At initial contract signing, the assets and liabilities may be equal and offsetting. If the assets and liabilities were subsequently measured at fair value, similar to a forward contract, those values could fluctuate depending on the length of time between contract signing and delivery. Statement 133 and IAS 39 contain scope exceptions for this type of transaction and therefore, under current GAAP, they would not be treated as derivatives and marked-to-market between contract signing and delivery.

33. The staff notes that upon delivery/acceptance of the leased item, the nature of the assets and liabilities changes for both the lessee and the lessor. For example, the conditional rights and obligations at contract signing become unconditional rights and obligations upon delivery/acceptance. It is at that point that the lessee has an unconditional right to use the leased item and an unconditional obligation to pay for that right and the lessor has an unconditional right to receive payments. Therefore, the staff recommends that only those assets and liabilities that arise upon delivery of/access to the leased item should be recognized upon delivery of/access to the leased item.

Questions for Board Members

1. **Do you agree with the staff's analysis that assets and liabilities arise upon contract signing?**

2. **The staff's recommendation is that assets and liabilities should only be recognized upon acceptance/delivery of the leased item for the reasons described in paragraph 32-33, above. Do you agree with the staff's recommendation?**

3. **If you do not agree with the staff's recommendation, do you believe that assets and liabilities should be recognized upon contract signing? If so, should those assets and liabilities be recorded gross or net?**

4. **Are there any other recognition points the staff should consider?**