30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board



**INFORMATION FOR OBSERVERS**

| | |
|---|---|
| **Board Meeting:** | **22 March 2007, London** |
| **Project:** | **Leases** |
| **Subject:** | **Identification of assets an liabilities arising in a simple lease (Agenda paper 12A)** |

## 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. The paper then considers 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 working definitions of assets and liabilities proposed in the Conceptual Framework project. The appendix to this paper includes both the current and the working definitions of assets and liabilities.

[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 considers it can identify the rights and obligations that are common to most lease contracts. More complex lease terms and the scope of the project will be considered at a later stage.

4. 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 will be discussed at a later stage of the project.

5. This paper is based on paper AP5 discussed at the Leasing Working Group meeting on 15 February 2007. The comments of Working Group members are summarised at the end of the paper.

6. This paper asks the Boards to consider and comment on the staff's preliminary analysis of the assets and liabilities arising in a simple lease contract.

## Promises exchanged and rights and obligations arising in a simple lease

7. The essential feature of a lease contract is that it gives one party (the lessee) the contractual 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).

8. In exchange for this right, the lessee incurs 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.

[2] In this paper, the term 'asset' is used only in relation to items that meet the conceptual framework definitions and is not used to refer to the physical machinery or other property that is the subject of the lease.

9. The staff have analysed the promises exchanged and the related 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 over the lease term after the machinery 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.*

10. Generally, in lease contracts the lessee is required to return the machinery to the lessor in a specified condition at the end of the lease term. In addition, the lessee may be required to incur costs to return the machinery to the lessor (for example, costs to dismantle the machinery and/or transportation costs) However, commitments of this type are ignored for the purposes of this simple example. The staff will consider such commitments at a later stage.

11. The lease described in this example is non-cancellable. That is, the lessee has no contractual right to terminate the lease agreement, return the machinery and cease making payments to the lessor. Equally, the lessor has no contractual right to terminate the lease agreement and demand the return of the machinery prior to the end of the lease term. Leases that incorporate a contractual right of termination (cancellable leases) will be considered at a later stage of the project.

12. The contractual promises exchanged and the related 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<br><br>• Right to receive payments during the lease term | • Right to use machinery for the lease term – the right to the economic benefits derivable from use of the machinery<br><br>• Obligation to make specified payments over the lease term |

| | |
|---|---|
| • Right to return of machinery at end of lease term<br><br>• 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) | • Obligation to return the machinery at the end of the lease term |

*Question for the Boards*

13. The staff would like the Boards to consider the following question:

| |
|---|
| • **Has the staff correctly identified the promises exchanged and the related rights and obligations arising in this simple non-cancellable lease contract?** |

## Application of asset and liability definitions

14. 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. The current and the proposed definitions are provided in the appendix.

15. 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:

- There is an economic resource or benefit that the reporting entity controls;
- It arises out of a past event; and
- Future economic benefits are expected to flow to the entity.

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

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

17. 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.

18. 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. For example, an asset or liability is recognised only if it is capable of being measured reliably. Consequently, the staff will not consider the detailed recognition criteria until the measurement of assets and liabilities arising in lease contracts has been discussed.

## 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?***

19. 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.

20. 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, it may forfeit its right to use the machinery since the lessor could seek to repossess the machinery 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.

21. However, the staff have tentatively concluded that under a non-cancellable lease the right to use the machinery and the obligation to pay for its use is 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, assuming the lessee's right to use

the item is not dependent on performance by the lessor, it is an unconditional right. 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.

22. 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.

23. Therefore, the staff have tentatively concluded that 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 (or breach of contract);

    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 the right to use the item during the lease term will flow to the lessee.

24. Accordingly, the staff have tentatively concluded that the lessee’s right to use the machinery for the lease term meets the Framework and CON 6 definition of an asset.

*Question for the Boards*

25. The staff would like the Boards to consider the following question:

- **Do the Boards agree with the staff’s preliminary analysis that under the simple non-cancellable lease described in this paper the lessee obtains a right to use the leased item that meets the definition of an asset? If not, why not?**

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

26. 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. That is, the lessee's promise to pay is conditional upon the lessor meeting its promise to provide the lessee with the machinery each day (and vice versa). This analysis would view the promises between the lessee and the lessor as concurrently conditional throughout the lease term.

27. However, under a non-cancellable lease the lessor has no contractual right to cancel the lease, nor the contractual right to take back possession of the item until the end of the lease term (assuming there is no breach). Therefore, the staff have tentatively concluded that the lessor has given the lessee an unconditional right to use the item. The lessee has no contractual 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 all of the lease payments due over the lease term. The staff consider that the promises exchanged between the lessee and the lessor in a simple, non-cancellable lease contract are unconditional.

28. In summary, for a non-cancellable lease, the staff have tentatively concluded:

    a. The lessee has a present obligation for all of the lease payments due over the lease term;

    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).

29. Accordingly, the staff have tentatively concluded that the lessee's obligation to make payments under a non-cancellable lease meets the Framework and CON 6 definition of a liability.

*Question for the Boards*

30. The staff would like the Boards to consider the following question:

- **Do the Boards agree with the staff's preliminary analysis that under the simple non-cancellable lease described in this paper the lessee has an obligation to pay for the leased item that meets the definition of a liability? If not, why not?**

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

31. 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.

32. It might seem that there is an 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).

33. However, the staff have tentatively concluded that there is no outflow of economic benefit from the lessee when it returns the machinery, (not taking into consideration any potential obligation associated with returning the item in a specified condition or any potential retirement costs associated with returning the item). 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.

34. Consequently, the staff have tentatively concluded 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 Boards*

35. The staff would like the Boards to consider the following question:

- **Do the Boards agree with the staff's preliminary analysis that under the simple non-cancellable lease described in this paper the lessee's obligation to return the leased item does not meet the definition of a liability? If you do not agree, why?**

***Summary***

36. The following tables summarise the lessee's rights and obligations under the lease contract after the delivery of the machinery assuming that once the machinery has been delivered, the lessee has an unconditional right to use that machinery during the lease term and that the lessee has an unconditional obligation to pay for this right of use:

| **Description of right** | **Control** | **Past event** | **Future economic benefit** | **Asset?** |
|---|---|---|---|---|
| Right to use machinery during the lease term | Legally enforceable right established by the lease contract | 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 | Legally enforceable obligation established by the lease contract | Delivery of machinery | Yes (cash payments) | Yes |
| Obligation to return the machinery at the end of the lease term | Legally enforceable 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

37. The staff considers that 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. Instead, the staff considers that under a non-cancellable lease, the right is unconditional once the machinery has been delivered. The lessee

can normally only avoid making payments under the lease contract if the lessor, in some way, breaks the terms of the lease contract.

38. 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.

39. In effect, the lessor has exchanged its rights to use the machinery 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.

40. 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.

41. 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, but rather existed before the lease contract. However, the residual rights are considered here for completeness. 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 legal ownership (property) 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.  Thus, these rights meet the definition of an asset.

42. 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, this is not the case once the

machinery is delivered to the lessee. The lessor has performed its obligation under the lease and generally does not have the contractual right to re-call the item from the lessee unless the lessee breaches the contract. 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).

43. The following tables summarise the lessor's rights and obligations after delivery of the machinery assuming that the lessor has an unconditional right to receive payments during the lease term and the lessor has residual ownership rights in the machinery:

| **Description of right** | **Control** | **Past event** | **Future economic benefit** | **Asset?** |
|---|---|---|---|---|
| Right to receive payments during the lease term | Legally enforceable right established by lease contract | Signing of lease contract and delivery of machinery | Yes (cash inflows) | Yes |
| Right to return of machinery at the end of the lease | Legally enforceable right | 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 property or contractual 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 | Legally enforceable obligation established by lease contract | Signing of the lease contract | There is no future outflow of economic benefit. | No |

*Question for the Boards*

44. The staff would like the Boards to consider the following question:

- **Do the Boards agree with the staff's preliminary analysis that under the simple lease described in this paper the lessor's obligation to**

**permit the use of the machinery by the lessee does not meet the definition of a liability? If you do not agree, why?**

## Application of conceptual framework project working asset and liability definitions

45. The proposed new definitions of assets and liabilities do not fundamentally change the concept of assets and liabilities. Rather they attempt to more clearly express the existing concepts and, therefore, provide a more disciplined means for analysing whether particular items meet the definitions.

46. 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.

47. 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

48. The following tables apply the working definitions of an asset and liability to the lessee's rights and obligations under the simple lease contract after the delivery of the machinery assuming that once the machinery has been delivered, the lessee has an unconditional right to use that machinery during the lease term and that the lessee has an unconditional obligation to pay for this right of use:

| **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 |

49. Thus, the staff's preliminary analysis of the terms of the lease contract result in similar assets and liabilities being identified under the working definition as under the existing definitions.

**Lessor assets and liabilities**

50. The following tables apply the working definitions of an asset and liability to the terms of the simple lease contract as they pertain to the lessor after the delivery of the machinery assuming that the lessor has an unconditional right to receive payments during the lease term and the lessor has residual ownership rights in 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 |

51. Thus, the staff's preliminary 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.

*Questions for the Boards*

52. The analysis above considers the preliminary working definitions of assets and liabilities in the conceptual framework project. The staff thinks that the working definitions of assets and liabilities identify the same assets and liabilities arising in this simple lease as the existing definitions. However, potential changes to the conceptual framework could result in different conclusions. For example, depending on how conditional and unconditional rights and obligations are defined, lease contracts could be viewed as executory contracts. Therefore, the staff recommend moving forward with the project under the existing definitions until the proposed framework definitions are finalised.

53. The staff would like the Boards to consider the following question:

- **Do the Boards agree with the staff's preliminary analysis that the working definitions of assets and liabilities identify the same assets and liabilities arising in this simple lease as the existing definitions? If not, why not?**
- **Should the staff base future work on the existing definitions of assets and liabilities, on the proposed working definitions, or should the staff consider both definitions?**

## Working Group comments

54. This paper is based on a paper discussed at the first Working Group meeting. The principal comments made by Working Group members were as follows:

a) Although the paper correctly identifies the rights and obligations arising in a simple non-cancellable lease, the example used ignores many of the complexities of real life leasing transactions;
b) Different tax and legal jurisdictions can affect the contractual rights and obligations arising in a lease.
c) Many leases are tax driven, specifically as it pertains to pricing (generally, tax benefits accruing to the lessor are passed through to the lessee via reduced interest rates). Consequently, the tax effects of the lease should be considered;
d) In practice, it is difficult to determine when a lease is non-cancellable. Many leases can be terminated if the lessee agrees to compensate the lessor for termination;
e) Identifying what is meant by the lease term may be difficult, especially considering penalties that make it probable that the lease term would be extended (compulsion);
f) Some questioned whether it is possible for the lessor to deliver the full right of use on delivery of the machinery;
g) Some questioned why we are examining the individual promises exchanged in the lease contract rather than analysing the lease contract in its entirety as the unit of account.
h) Some argued that the lessee's obligation to return the machinery at the end of the lease could be viewed as a liability as it is similar to a borrower repaying the principal on a loan.
i) Some questioned whether very short leases could give rise to an asset, or are merely executory contracts;
j) Distinguishing between a right of use and a right to the output of an asset was considered important.

# APPENDIX – ASSET AND LIABILITY DEFINITIONS

## Existing definitions

### Existing definitions of asset

The existing IASB and FASB definitions of an asset are as follows:

*IASB*

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. (Framework, paragraph 49)

*FASB*

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (CON 6, paragraph 25)

### Existing definitions of liability

The existing IASB and FASB definitions of a liability are as follows:

*IASB*

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (Framework, paragraph 49)

*FASB*

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (CON 6, paragraph 35)

# Working definitions

## Working draft of proposed asset definition

An asset is a present economic resource to which the entity has a present right or other privileged access.

a. *Present* means that both the economic resource and the right or other privileged access to it exist on the date of the financial statements.

b. An *economic resource* is something that has positive economic value. It is scarce and capable of being used to carry out economic activities such as production and exchange. An economic resource can contribute to producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources include non-conditional contractual promises that others make to the entity, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. *A right or other privileged access* enables the entity to use the present economic resource directly or indirectly and precludes or limits its use by others. *Rights* are legally enforceable or enforceable by equivalent means (such as by a professional association). Other privileged access is not enforceable, but is otherwise protected by secrecy or other barriers to access.

**Working draft of proposed liability definition**

A liability is a present economic burden for which an entity has a present obligation.

a. *Present* means that both the economic burden and the obligation exist on the date of the financial statements.

b. An *economic burden* is something that has negative economic value. It is capable of requiring the sacrifice of economic resources. An economic burden can require cash outflows or reduce cash inflows, directly or indirectly, alone or together with other economic burdens. Economic burdens include non-conditional contractual promises that the entity makes to others, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. An *obligation* requires the entity to bear the present economic burden directly or indirectly. Obligations are legally enforceable or enforceable by equivalent means (such as by a professional association).