Project **Leases**

Topic **Timing of initial recognition**

Purpose

1. The purpose of this paper is to determine when initial recognition of assets and liabilities in a lease contract should take place.

2. In previous discussions, the boards have decided that a right-of-use asset and an obligation to pay rentals exist after delivery of the right-of-use asset to the lessee. However, the staff were asked to consider whether assets and liabilities arise before delivery (eg on contract signing).

3. In this paper, the staff conclude that assets and liabilities arise on contract signing. However, until either the lessor or the lessee has performed any of their promises under the contract (for example, delivery of the leased item or making a lease payment), the contract is executory.

4. Consequently, the staff recommend recognising a net contract asset or liability upon contract signing. The staff do not recommend remeasuring that asset or liability and proposes requiring additional disclosures to enable users to understand an entity's contractual position.

Structure of the paper

5. This paper contains the following:

(a) Background information

(b) Staff analysis on:

  (i) whether assets and liabilities arise upon contract signing

  (ii) whether to present assets and liabilities in a contract gross or net upon contract signing

  (iii) initial and subsequent measurement of assets and liabilities between contract signing (the inception date) and delivery of a leased item (the commencement date)

  (iv) Disclosures where a net contract position is not remeasured between contract signing (the inception date) and delivery of a leased item (the commencement date)

(c) Staff recommendations and questions

(d) Appendix - Feedback from respondents to the Leases Discussion Paper.

Background

6. In the Leases discussion paper, the boards identified and analysed the rights and obligations arising in a simple lease contract and compared those rights and obligations to the boards' definitions of assets and liabilities. The boards tentatively concluded that the lessee's right to use a leased item for the lease term meets the definition of an asset, and the lessee's obligation to pay rentals meets the definition of a liability in accordance with the boards' frameworks.

7. However, to simplify their analysis, the boards considered only those rights and obligations that exist after the leased item is delivered to the lessee. The boards have not reached a preliminary view on whether assets and liabilities arise before delivery of the leased item (eg when the contract is signed).

8. Therefore, this paper will discuss whether the rights and obligations arising upon signing of a lease contract meet the boards' definitions of assets and liabilities. If so, the staff then will analyse how those assets and liabilities should be presented in the financial statements.

9. The staff acknowledges that lease contracts sometimes include the construction of a leased item before delivery. Some staff think that under the proposed new right-of-use model, such contracts have two elements, a construction element and a lease element. The element of the contract requiring construction of an underlying asset does not grant a right to use the underlying asset to the lessee. Consequently, it is outside the scope of the leases project. However, staff will analyse this issue further and consider whether additional guidance is needed for contracts of this type at a later stage in the project.

Staff Analysis

10. The staff will focus its analysis on whether an item meets the definitions of an asset and a liability in accordance with the FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (CON 5) and a precondition of recognition under the IASB *Framework for the Preparation and Presentation of Financial Statements* (Framework). The staff assumes that for most lease contracts the recognition criteria in CON 5 and the Framework will be met once the definition of an asset or a liability has been met.

11. The staff will use the same simple lease example discussed in the Leases discussion paper:

    A machine is leased for a fixed term of five years; the expected life of the machine is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machine 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 machine has been delivered; these are fixed amounts that are specified in the original agreement. No maintenance or other arrangements are entered into.

Identification of Assets and Liabilities upon Contract Signing

12. The first date on which assets and liabilities may arise is when the 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 contract signing. The contract sets out contractual (ie enforceable) rights and obligations for both the lessee and the lessor. The question is whether those rights and obligations give rise to assets and liabilities.

13. In the simple lease contract described above, two sets of promises are exchanged.

The lessor promises to:	The lessee promises to:
(a) deliver the right to use the machine to the lessee (b) stand ready to accept payments.	(a) accept delivery of the right to use the machine (b) stand ready to make lease payments

14. Upon contract signing (*a past event*), the contract binds the lessor and the lessee to perform the promises specified in the contract. In the simple lease example, the lessor has a *present obligation* to deliver the right to use the machine, resulting in an *outflow of economic benefits*. The lessee's right to use the machine for a specified future period is its economic resource. The lessee can use the machine to produce goods for sale or provide services from, or the lessee can lease the machine to another party. *Future economic benefits* will flow to the lessee from the right to use the machine during the lease term.

15. Conversely, the lessee's promise to stand ready to pay rentals is a *present obligation* and will result in an *outflow of economic benefits*. The lessor's right to receive rentals over the lease term is its economic resource. Those payments (*future economic benefits*) are expected to flow to the lessor from the lessee.

16. Unless either party breaches the contract, those contractual rights and obligations are unconditional. The lessee has an unconditional right to receive the right to use the leased item and an unconditional obligation to stand ready to pay rentals for that right. Equally, the lessor has an unconditional obligation to deliver the right to use the leased item and an unconditional right to the lessee's promise to pay rentals.

17. In summary, the following assets and liabilities can be identified upon the contract signing in the simple lease example:

	Description of right	Control	Past event	Future economic benefits?	Asset?
Lessor	Right to lessee's promise to pay (to receive payments)	Legally enforceable right established by the contract	Contract signing	Yes (cash payments)	Yes
Lessee	Right to lessor's promise to deliver (to receive right to use machine during the lease term)	Legally enforceable right established by the contract	Contract signing	Yes	Yes

	Description of obligation	Present obligation	Past event	Outflow of economic benefits?	Liability?
Lessor	Obligation to deliver right to use machine	Legally enforceable obligation established by the contract	Contract signing	Yes	Yes
Lessee	Promise to stand ready to pay	Legally enforceable obligation established by the contract	Contract signing	Yes (cash payments)	Yes

18. The above example requires the lessor to perform first (that is, the lessor is required to deliver the asset that underlies the right-of-use asset, namely the machine). Other leases may require the lessee to perform first by making a lease payment. If this is the case, the lessee has a *present obligation* to pay rentals, resulting in an

outflow of economic benefits upon contract signing (*a past event*). At the same time, the right to receive payments over the lease term is controlled by the lessor. Those payments (*future economic benefits*) are expected to flow to the lessor from the lessee. Thus, the lessee has a liability and the lessor has an asset.

19. The lessor's promise to stand ready to deliver the right to use the machine is a *present obligation* and will result in an *outflow of economic benefits*. The lessee has a corresponding right, which is the right to the lessor's promise to deliver the right to use the machine. *Future economic benefits* will flow to the lessee from the use of the machine during the lease term. This gives rise to a liability for the lessor and an asset for the lessee.

20. This demonstrates that, although the lessee and the lessor have different assets and liabilities depending on which party performs first, the promises exchanged in both scenarios result in assets and liabilities at the contract signing.

Question 1
The staff think that assets and liabilities arise upon contract signing. Do the boards agree with that staff's analysis?

Presentation of Assets and Liabilities upon Contract Signing

21. The staff thinks that there are two possible approaches to present the contractual rights and obligations that meet the definitions of assets and liabilities upon contract signing:
    (a) separation of the right and obligation (unit of account is the individual rights and obligations) or
    (b) combination of the right and obligation giving rise to a *single* asset or liability (unit of account is the contract as a whole).

Approach A: separation of the right and obligation (unit of account is the individual rights and obligations)

22. The staff identified the following advantages to approach A:

(a) It is consistent with the proposed right-of-use model. Under the model, the right-of-use asset and the obligation to pay rentals are presented separately.

(b) It may provide more information to users of financial statements during the time between contract signing and delivery.

23. However, the staff noted the following disadvantages to requiring separate identification, recognition and measurement of the rights and obligations upon contract signing:

(a) It may be more complex for preparers to apply.

(b) It is inconsistent with the treatment of other executory contracts and forward contracts.

(c) It is inconsistent with current lease accounting requirements.

Approach B: combination of the right and obligation giving rise to a single asset or liability (unit of account is the contract as a whole)

24. Under this approach, an entity recognises *either* a contract asset *or* a contract liability that reflects its *net* position in the contract with respect to the remaining (ie unperformed) rights and obligations in the contract.

25. The staff identified the following advantages to approach B:

(a) It is simpler and less costly for preparers to apply.

(b) It is consistent with the way many other executory contracts and forward contracts are recognised and measured.

(c) It is consistent with the boards' proposals in the revenue recognition discussion paper.

(d) It is consistent with the current lease accounting guidance on initial recognition (at the commencement of the lease term).

26. Until either the lessee or the lessor has performed any of their promises under the contract, the contract is executory. The unit of account for executory contracts is normally the contracts as a whole. Since the unit of account is the contract as a whole, only a net asset or liability is recognised (assets and liabilities are netted).

27. In addition, between contract signing and delivery, the contract is effectively a forward contract (a contract for delivery of a right to use an asset). Under current standards, forward contracts are either treated as derivatives or not recognised at all. Theoretically, it may be appropriate for the lessee and the lessor to recognise this forward contract as a derivative. If the assets and liabilities were subsequently measured at fair value similar to a forward contract, those amounts could fluctuate depending on the length of time between contract signing and delivery.

28. However, under IFRS lease contracts would not be treated as derivatives and marked-to-market between contract signing and delivery because the contract signed at specified terms is akin to a "normal purchase and sale" and normal purchase and sale transactions are explicitly scoped out of IAS 39, *Financial Instruments: Recognition and Measurement* (Paragraph 5). In US GAAP (ASC 815-10-15, *Derivative and Hedging*), contracts of this type do not meet the definition of a derivative.

29. As part of the revenue recognition project, the boards discussed when the unit of account for a contract should be the contract as a whole rather than the individual rights and obligations. The boards concluded that the unit of account should be the contract as a whole if: the rights and obligations in the contract are interdependent; and the rights and obligations in the contract are with same counterparty.

30. Those conditions are met for a contract prior to delivery of the right-of-use asset. Once the right-of-use asset is delivered to the lessee (upon delivery/acceptance of the leased item), both parties have performed the remaining (ie unperformed) rights and obligations in the contract. Thus, at that point, gross presentation of rights and obligations provides the most useful information to users (ie under the proposed right-of-use model, the right-of-use asset and the obligation to pay rentals are presented gross).

Question 2

> The staff recommend that the boards decide tentatively that between contract signing and delivery the unit of account is the contract as a whole and the contract position is presented net in the statement of financial position of both the lessee and lessor.
>
> Do the boards agree with that staff's recommendation?

Initial and Subsequent Measurement of Assets and Liabilities between Contract Signing and Delivery of the Leased Item

31. If approach B is adopted (net presentation), initial measurement of most contracts will be zero because at contract signing the initial measurement of the rights would equal the amount of the obligations.

32. Between contract signing and delivery, the boards could decide to require measurement of the assets and liabilities at cost or to require remeasurement of those assets and liabilities.

33. The following table summarises possible approaches for initial and subsequent measurement of assets and liabilities in a contract.

	Initial measurement (upon contract signing)	Subsequent measurement (between contract signing and delivery)
Gross (Approach A)	Asset and liability	Cost or Remeasurement of asset and liability
Net (Approach B)	Asset and liability net to zero	Cost (net to zero) or Remeasurement of asset and liability

34. Although the staff thinks that requiring remeasurement may provide more relevant information to users, the staff does not recommend that approach due to the following reasons:

(a) It would be complex and costly for preparers. The costs associated with the remeasurement may outweigh the benefits.

(b) It is inconsistent with the treatment of many other non-financial executory and forward contracts that do not meet the definition of a derivative or are not required to be accounted for as derivatives.

Question 3
The staff recommend that the boards decide tentatively to initially and subsequently measure the assets and liabilities (the net contract position) in a contract on a cost basis. Do the boards agree with that staff's recommendation?

Disclosures

35. In most lease contracts, the time between contract signing and delivery of the right-of-use asset to the lessee is short. However, when the period between contract signing and delivery is long and/or the rights and obligations are significant, users may benefit from additional information about the nature of the contractual rights and obligations of the parties arising in the contracts.

36. For example, material contracts signed but not recognised at the reporting date would be disclosed including:

(a) a description of the nature of the leased asset

(b) the expected delivery date of the right-of-use asset

(c) the present value of the lease payments

(d) the length of the lease.

Question 4
The staff recommend that the boards require additional disclosures in situations where the time between contract signing and delivery is long and/or the rights and obligations are significant. Do you agree with that staff's recommendation?

Appendix - Feedback on the topic of timing of initial recognition from respondents to the Leases Discussion Paper

A1. This appendix summarises the feedback received from comment letters with respect to the timing of initial recognition.

A2. Most respondents made no comment on this issue. Those who did comment expressed the view that assets and liabilities in lease contracts should be recognised upon delivery/acceptance of the leased item. They noted that the accounting treatment should be:

(a) consistent with the timing of initial recognition of other non-financial assets

(b) consistent with the treatment of non-financial executory contracts

(c) consistent with existing standards (assets and liabilities are recognised upon commencement of the lease)

(d) consistent with the boards' proposals for revenue recognition.

A3. A respondent commented that recognising assets and liabilities at the inception date would be simpler than recognising them at the commencement date. However, the respondent did not explain why.

A4. In addition, a respondent suggested that the boards should consider the accounting for contracts when there is a significant gap between the inception date and the commencement date.