Project **Leases**

Topic **Measurement at initial recognition**

Purpose

1. At their October 2009 joint meeting, the boards discussed whether an entity should recognise any assets or liabilities during the period between the signing of a lease contract (the inception date) and the delivery of the underlying asset to the lessee (the commencement date).

2. The boards tentatively decided that:

   (a) assets and liabilities arise when a contract is signed

   (b) between contract signing and delivery, the unit of account is the contract as a whole and the contract position would be presented net in the statement of financial position of both the lessee and lessor

   (c) an entity would initially and subsequently measure the net contract asset or liability on a cost basis, subject to impairment (generally initial measurement of the contract asset would equal the initial measurement of the contract liability)

   (d) an entity would provide disclosures about the assets and liabilities that arose upon contract signing, including a description of the nature of the underlying asset, the expected delivery date, the present value of the lease payments and the length of the lease.

3. The boards did not reach a preliminary view on whether initial measurement of the assets and liabilities should be determined at the inception date or at the commencement date.

4. This paper provides that additional analysis.

5. The staff recommend that the initial measurement of the assets and liabilities arising in lease contracts should be determined at the inception of the lease.

Staff analysis

6. IAS 17, *Leases*, defines inception of the lease as the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. At the inception of the lease, a lease is classified as either an operating or a finance lease. In the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined at the inception of the lease.

7. Further, paragraph 20 of IAS 17 states that to recognise finance leases as assets and liabilities at the commencement of the lease term, lessees would determine the present value of the minimum lease payments at the inception of the lease.

8. Similarly, Topic 840, *Leases*, of the *FASB Accounting Standards Codification*™ defines lease inception as the date of the lease agreement or commitment, if earlier.

9. Also, paragraph 840-10-25-1 states that a lessee and lessor shall classify the lease at its inception based on the four criteria. One of those four criteria (minimum-lease-payments criterion) includes determining the present value of the minimum lease payments at lease inception.

10. Therefore, it is clear that under both IFRS and U.S. GAAP the inception date is the date when the amounts to be recognised at the commencement of the lease term are determined.

11. Consequently, the staff question whether there should be the same requirement in the proposed new leases requirements.

12. The staff think that initial measurement should be determined at the inception of the lease because it is when the lessee and lessor enter into a lease contract and the principal provisions of the lease (including the expected delivery date) are determined.

13. In addition, requiring the lessee and lessor to determine the amounts of assets and liabilities recognised in their financial statements at the inception date would be consistent with the existing guidance. Therefore, it can be argued that the costs of changing would outweigh the benefits.

14. The commencement date could be any future date, and facts or circumstances that existed at lease inception may no longer be applicable at the commencement. Therefore, measurement at that date could be any value, depending on forward rates. Determining a forward incremental borrowing rate for lessees would add complexity to the new leases requirements.

Implications on the proposed new leases requirements

Discount rate

15. Under the proposed right-of-use approach to lessee accounting, the obligation to pay rentals and the right-of-use asset would be measured initially at the present value of the lease payments, discounted using the lessee's incremental borrowing rate. The lessee can use the rate that the lessor is charging the lessee as the discount rate if it is a reasonable approximation to the incremental borrowing rate and can be determined reliably.

16. For lessor accounting, the initial measurement of the lessor's receivable and its performance obligation would be at the present value of the lease payments, discounted using the interest rate being charged by the lessor plus any initial direct costs incurred by the lessor.

17. The boards have tentatively decided that the discount rate would not be adjusted for any changes to the lease payments after initial recognition.

18. Therefore, if the measurement of lease assets and liabilities is determined at the inception date, the discount rate to be used to present value the lease payments

will be fixed at lease inception. The staff think that the rate determined at the inception of the lease is more appropriate than the rate at the commencement of the lease term because the inception date is when the lessee and lessor enter into a lease contract and determine the terms of the lease, including the rates being charged to the lessee.

19. However, some would argue that a forward rate is better than the rate at the inception, particularly if there is a long delay between contract signing and delivery. This is because the forward rate reflects the rate for the period from the commencement of the lease term to the end of the lease term.

20. For lessors, if that period is significant, the rate the lessor is charging the lessee is likely to be the forward rate. Therefore, requiring the lessor to use "the rate the lessor is charging the lessee" at lease inception will get to the forward rates. Using the forward rate better reflects the economics of the transaction in these circumstances.

21. However, requiring the lessee to determine a forward incremental borrowing rate to discount the lease payments may be complex when the period between lease inception and commencement is significant.

22. Therefore, the staff think that although using forward rates may provide better information, initially measuring lease assets and liabilities using the rates existing at the inception of the lease is simpler to apply. Measurement using forward rates would add complexity to the new leases requirements.

Changes between the inception of the lease and the commencement of the lease term, including options and contingent rentals

23. For any changes between the inception of the lease and the commencement of the lease term, paragraph 20 of IAS 17 states that:

> A lease agreement or commitment may include a provision to adjust the lease payments for changes in the construction or acquisition cost of the leased property or for changes in some other measure of cost or value, such as general price levels, or in the lessor's costs of financing the lease, during the period between the inception of the lease and the commencement of the lease term. If so, the effect of any such changes shall be deemed to have taken place at the inception of the lease for the purposes of this Standard.

24. The definition of lease inception in the Master Glossary Codification also states that if any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

25. From that existing guidance in IAS 17 and Topic 840, lease inception is further clarified as the date of the lease agreement or commitment when there are no more changes in the principal provisions of the lease. Therefore, the measurement of lease assets and liabilities (that will be recognised at the commencement of the lease term) would take into account all changes in the lease payments between contract signing and delivery.

26. Under the proposed new leases requirements, the obligation to pay rentals recognised by the lessee and the receivable recognised by the lessor would include amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees.

27. Consistent with the decision to estimate amounts payable in optional periods, under contingent rental arrangements and/or residual value guarantees, if there is a change in those estimates during the period between contract signing and delivery, the lease payments recognised at commencement would be adjusted.

Staff recommendation

28. The staff recommend that an entity should *recognise* the gross value of assets and liabilities arising in lease contracts at the *commencement* of the lease term. Those assets and liabilities should be *measured* at the *inception* of the lease. Any changes in the measurement of the lease payments (eg options, contingent rentals, etc.) between the inception of the lease and the commencement of the lease term would adjust the amounts of assets and liabilities to be recognised at the commencement because:

    (a) it would be conceptually correct to determine initial measurement at the inception of the lease.

    (b) it would not change existing guidance, and thus would be consistent with current practice.

(c) it would reduce complexity to the new leases requirements.

29. This means that the discount rate to be used to present value the lease payments will be fixed at lease inception.

Question 1

The staff recommend that an entity should *recognise* the value of assets and liabilities arising in lease contracts at the *commencement* of the lease term. Those assets and liabilities should be *measured* at the *inception* of the lease. Any changes in the measurement of the lease payments (eg options, contingent rentals, etc.) between the inception of the lease and the commencement of the lease term would adjust the amounts of assets and liabilities to be recognised at the commencement

Do the boards agree? If not, why?