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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 November 2008, London**

Project: **LEASE ACCOUNTING**

Subject: **Presentation of Leases (Agenda Paper 8C)**

Introduction

1. The boards have tentatively decided that all leases give rise to:
   (a) a right to use the leased item that meet the definition of an asset (the right-of-use asset)
   (b) an obligation to pay rentals that meets the definition of a liability.
2. Agenda paper 8B discusses subsequent measurement of these assets and liabilities and asks the boards to decide whether:
   (a) all leases give rise to interest expense and amortization/depreciation
   (b) some categories of leases give rise to rental expense only.
3. The purpose of this paper is to ask the boards how these assets, liabilities and expenses should be presented in the statement of financial position and the income statement.
4. This paper is based on existing presentation requirements. The staff will consider the effect of the proposed changes arising from the Financial Statement Presentation project at a later stage of the project.

Presentation requirements of the existing standards

5. IAS 17 and Statement 13 currently require lessees to classify all lease contracts as either a finance (capital) lease or an operating lease. Leased assets recognized as finance leases are presented in the statement of financial position as property, plant and equipment (unless the lease is for an intangible asset under IAS 17, in which case it is presented as an intangible). This is consistent with the presentation of a purchase of the underlying leased asset.

6. Obligations under a finance lease are presented as liabilities in the statement of financial position and are classified as current or non-current as appropriate. Statement 13 explicitly requires the lease obligation to be separately identified in the statement of financial position.

7. Statement 13 states that finance leases give rise to amortization and requires the lessee to either include the amortization expense with depreciation expense on owned assets or present it separately in the financial statements. IAS 17 states that finance leases give rise to depreciation expense that should be recognized consistent with owned assets. There is no guidance on whether the interest component of the lease obligation should be presented separately or as a part of total interest expense.

Presentation of the right-of-use asset

8. The staff have identified three possible ways to present the right-of-use asset in the statement of financial position:

   (a) present the right-of-use asset based on the nature of the underlying leased item. For example, a lease of a motor vehicle would be presented in the statement of financial position with other motor vehicles. Owned motor vehicles could be presented as a separate line item from motor vehicles that are leased.

   (b) present the right-of-use asset as an intangible asset.

   (c) use a different presentation for the different types of lease. For example, leases that are in substance purchases could be presented based on the underlying asset (generally as property, plant, and equipment). All other right-of-use assets would be presented as intangible assets.

9. Some of the advantages and disadvantages of each of these approaches are discussed below.

10. Regardless of the approach selected by the boards, the staff notes that disclosures will likely be needed to supplement the presentation. For example, users would benefit from knowing whether the amount presented for leases is composed of a large number short-term leases or a smaller number of long-term leases.

Presentation based upon the nature of the underlying asset

11. The staff have identified the following advantages to this approach to presentation:

    (a) It provides users with information about the nature of the leased asset that could be lost if the right of use is presented as an intangible. For example, some rights to use may be of property, plant, and equipment, while other rights to use may be of intangible assets. This approach differentiates between these two different types of leases. Additionally, users are interested in the productive capacity of a business in order to asses the ability of the business to generate positive cash flows. Presenting rights to use based on the underlying accurately reflects the productive capacity of a business to produce its products or provide its services.

    (b) It is consistent with the way in which the lessee uses the right-of-use asset in their normal course of business. For example, a lessee uses a right to use a motor vehicle the same way that a lessee uses an owned motor vehicle.

    (c) It avoids the need to retain the classification requirements to distinguish between in-substance purchases and other right-of-use assets as the presentation is the same whether the lease is an in-substance purchase or a lease of the asset.

    (d) Many right-of-use assets are similar to owning the underlying asset for a term less than its useful life. As such, arguably, the presentation should reflect the similarities between the right to use and the underlying.

    (e) It is consistent with the approach in current standards.

12. However, the staff notes that a short-term right of use is a very different asset from outright ownership of the leased item– failing to differentiate between the two may not meet the needs of financial statement users. Hence, if the boards adopt this approach they may need to distinguish between leased assets and owned

assets. This could be achieved by presenting motor vehicles that are leased (for example) adjacent to but separately from motor vehicles that are owned. Alternatively, they could distinguish between leased assets or owned assets by way of disclosure.

Presentation as an intangible

13. Presenting the right-of use asset as an intangible asset has two main advantages:
    (a) It clearly differentiates leased assets from owned assets, which may be important to users.
    (b) It is conceptually appealing. The asset arising in a lease contract is not the underlying asset itself; rather, it is a *right* to use the underlying. Other rights to use, such as a license, are accounted for, and presented as, intangible assets in the statement of financial position.

14. However, this approach fails to provide users with information about the nature of the underlying asset, such as the productive capacity of the business or information about how the business uses the leased asset in its normal course of business.

15. In addition, this approach raises a problem for in-substance purchases. Treating an in-substance purchase of a piece of equipment as an intangible asset would be potentially misleading for users. This problem could be avoided if you retained some form of classification requirement. This is approach (c).

Presentation based on classification

16. This approach would allow users to differentiate between in-substance purchases and other leases. However, it has a number of disadvantages:
    (a) Many leases would be classified as intangible assets. Consequently, information about the nature of the underlying asset will be lost for these leases.
    (b) This approach adds significant complexity to the standard, as guidance on differentiating in-substance purchases from other leases will have to be developed.
    (c) If the classification requirements are similar to those in the existing standards, economically similar leases may be presented differently, which would reduce comparability for users.

Staff Recommendation

17. The staff recommends approach (a). That is, to present the right-of-use asset based upon the nature of the underlying asset. The staff believes that this approach provides useful information about the nature of the leased item and is consistent with the way in which the lessee uses the right-of-use asset in their normal course of business.

18. The staff acknowledges that a short-term right of use is a very different asset from outright ownership of the leased item–failing to differentiate between the two may not meet the needs of users. Accordingly, the staff recommends that leased assets be presented separately from, but adjacent to, owned assets.

Questions for the boards

Q1: Do the boards agree with the staff recommendation to present the right-of-use asset based on the nature of the underlying asset? If you disagree, please explain why.

Q2: Do the boards agree with the staff recommendation to present the right-of-use assets adjacent to, but separately from, owned assets in the statement of financial position? If you disagree, please explain why.

Presentation of the obligation to pay rentals

19. The staff believes that presentation of the obligation to pay rentals does not give rise to significant presentation issues. It is a financial liability and should be presented as such in the statement of financial position.

20. The staff notes that an obligation to pay rentals is different from many other financial liabilities in that it is 'linked' to the right-of-use asset. Consequently, the boards may decide that it should be presented separately from other financial liabilities. However, the staff notes that the obligation to pay rentals is similar to a secured borrowing. IFRS and US GAAP do not require separate presentation of secured borrowings in the statement of financial position.

21. The staff believes that a separate presentation may provide users with more information about the lease obligation. However, the staff notes that this information could be included in additional disclosures, rather than included on the face of the financial statements. For example, IAS 39, *Financial Instruments: Recognition and Measurement*, and Statement 140, *Accounting for Transfers and*

Servicing of Financial Assets and Extinguishments of Liabilities, do not require separate presentation for the obligation in a secured borrowing. However, specific disclosures about secured borrowings are required.

Staff Recommendation

22. The staff recommends that the lease obligation be presented as a financial liability in the statement of financial position. The staff notes that a different presentation for the lease obligation from any other financial liability, such as a loan, would result in different presentation for a loan used to purchase property, plant and equipment and a lease obligation incurred to use property, plant, and equipment.
23. Additionally, the staff does not recommend that lease obligations be presented separately from other financial liabilities in the statement of financial position. The staff believes that the unique features of a lease obligation do not warrant separate presentation and notes that separate presentation of the lease obligation would not be comparable with economically similar obligations. However, the staff recommends that separate presentation should be permitted.
24. The staff believes that additional disclosures should be required regarding the total amount of the lease obligation, a description of the terms of the lease, and assumptions used when measuring the obligation. However, the staff will address the disclosures at a later stage of the project after receiving feedback from users through direct outreach and the Discussion Paper.

Questions for the boards

Q3: Do the boards agree that the obligation to pay rentals should be presented as a financial liability in the statement of financial position? If you disagree, please explain why.

Q4: Do the boards agree with the staff recommendation that obligations to pay rentals should not be required to be presented separately from other financial liabilities? If you disagree, please explain why.

Income Statement Presentation

25. The staff notes that the boards' decisions regarding both subsequent measurement and presentation of the assets and liabilities arising in a lease contract will drive income statement presentation.

26. Agenda paper 8B describes two different approaches to subsequent measurement of the lessee's right-of-use asset and obligation to pay rentals. Under approach A, the lessee recognizes interest cost and amortization/depreciation in the income statement. Under approach B, the lessee will recognize rental expense.

27. If the boards decide to require the lessee to recognize rental expense rather than interest and depreciation/amortization (approach B), the lessee will present rentals paid as an operating expense.

28. If however, the boards decide to require approach A, the lessee will present interest expense and amortization/depreciation in the income statement.

29. Whether the lessee presents amortization or depreciation in the income will depend upon the boards' decisions regarding the presentation of the right-of-use asset. For example, if the boards decide to present the right-of-use asset as an intangible asset, the expensing of the right-of-use asset will be presented as amortization expense. On the other hand, if the boards decide to present the right-of-use asset as property, plant and equipment, the expense will be presented as depreciation.

30. Additionally, if the boards decide to require separate presentation of leased assets and the corresponding lease obligation in the statement of financial position, the boards may also decide to require separate presentation on the face of the income statement of the related expenses. The staff will not ask the boards to decide whether depreciation/amortization and interest expense recognized under a lease should be presented separately at this meeting. Rather, the staff will include a question in the Discussion Paper for financial statement users to see if a separate presentation would be beneficial. For example, users may believe that interest expense should be presented separately because of the unique economics of a lease obligation, as compared with unsecured borrowings.