Project	**Leases**
Topic	**Lessee accounting - Presentation**

Purpose

1. The purpose of this paper is to discuss how a lessee's assets, liabilities, expenses and cash flows arising from a lease contract should be presented in the financial statements.

Structure of the paper

2. The structure of the paper is as follows:
   - (a) staff recommendation
   - (b) background information
   - (c) presentation of a lessee's assets, liabilities, expenses and cash flows arising from a lease contract in accordance with **current** presentation requirements in IFRSs and US GAAP:
     - (i) presentation of the obligation to pay rentals in the statement of financial position (SFP)
     - (ii) presentation of the right-of-use asset in the SFP
     - (iii) presentation in the statement of comprehensive income (SCI)
     - (iv) presentation in the statement of cash flows (SCF)

(d) presentation of a lessee's assets, liabilities, expenses and cash flows arising from a lease contract in accordance with the **proposed** presentation requirements in the forthcoming exposure draft (ED) *Financial Statement Presentation*.

Staff recommendation

3. In light of **current** presentation requirements, the staff recommend that a lessee:

   (a) present separately its obligation to pay rentals from other financial liabilities in the SFP;

   (b) present separately its right-of-use asset from other assets in the SFP based on how the underlying asset is used (eg property, plant or equipment);

   (c) both amortisation and interest expense arising in lease contracts should be separated from other amortisation expense and other interest expense either on the face of the statement of comprehensive income or in the notes of financial statements; and

   (d) both cash repayments of amounts borrowed and interest payments arising in lease contracts should be classified as financing activities in the statement of cash flows.

4. In light of the boards' **in-process** work on financial statement presentation (FSP), the staff expect that the forthcoming FSP ED will result in the classification of:

   (a) the right-of-use asset in the operating category of the SFP;

   (b) the amortisation of the right-of-use asset as an expense in the operating category of the SCI;

   (c) the obligation to pay rentals as a liability in the financing arising from operating activities sub-category in the SFP;

(d) the interest expense on the obligation to pay rentals as a financing cost in the financing arising from operating activities sub-category in the SCI; and

(e) the cash rental payments in the operating category of the SCF (as there is no sub-category for financing arising from operating activities in the SCF).

Background

5. In the March 2009 Discussion Paper (DP) *Leases: Preliminary Views*, the boards tentatively decided that lease contracts give rise to the following assets, liabilities, expenses and cash flows for lessees:

   (a) an obligation to pay rentals

   (b) a right-of-use asset

   (c) amortisation expense

   (d) interest expense

   (e) cash rental payments.

6. The IASB tentatively decided not to require separate presentation of the lessee's obligation to pay rentals in the SFP. However, the FASB tentatively decided to require separate presentation of the obligation.

7. The boards tentatively decided that a right-of-use asset should be presented separately from owned assets. The boards also tentatively decided that the right-of-use asset should be presented in the SFP based on the nature of the underlying asset.

8. The boards have not reached a preliminary view on how the expenses and cash flows associated with lease contracts should be presented in the SCI and the SCF, respectively.

9. The staff acknowledge that there is always trade-off between presentation on the face of the financial statements and disclosure in the notes to financial statements. Presentation and disclosure are interchangeable to some extent.

10. Therefore, the boards need to consider a) whether information presented in one way or the other makes a difference in decision-making and b) if so, which information should be presented in a particular way to make the information provided in financial statements more understandable and useful.
11. IAS 1, *Presentation of Financial Statements* states that an entity shall present additional line items, headings and subtotals in the statement of financial position and in the statement of comprehensive income when such presentation is relevant to an understanding of the entity's financial position and financial performance, respectively.
12. Proposed disclosure requirements for lessees are discussed in a separate paper.

Presentation of the obligation to pay rentals in the statement of financial position

13. More than half of the respondents to the Leases DP agree with the FASB's preliminary view that the obligation to pay rentals should be presented separately in the SFP because it is a unique class of liability that is linked to a corresponding asset.

14. Those respondents note that separate presentation is necessary to understand whether a lease liability has a risk profile that differs from other financial liabilities. For example, the obligation to pay rentals may include amounts payable in an optional period and/or under contingent rental arrangements.

> These obligations constitute a separate class of financial liability, because they are measured differently. In some ways they have more in common with provisions, because their measurement involves placing a value on uncertainties. (CL #5)

15. Respondents that do not support the separate presentation of a lease liability in the SFP think that the information is better disclosed in the notes to financial statements. Some of those respondents think that separate presentation in the SFP does not provide useful information to users of financial statements. Further, those respondents think that a lease liability should be presented in the same way as other financial liabilities.

16. However, the majority of respondents that agree with the IASB's preliminary view to not require separate presentation of a lease liability suggest that additional note disclosures should be required. They note that those disclosures should be sufficient to allow a financial statement user to determine how much of an entity's liabilities relate to lease contracts.

Staff analysis and recommendation

17. In the DP, the boards noted that the lessee's obligation to pay rentals is a financial liability and should be presented as such in the statement of financial position. Therefore, it can be argued that separate disclosure in the notes would be sufficient.
18. However, the boards tentatively decided to specify the required accounting for the obligation to pay rentals because the obligation is different from many other financial liabilities.
19. The staff think that an entity should be required to present separately its lease liability in the SFP because:
    (a) that presentation provides users of financial statements with information that is important to understand how an entity uses lease arrangements.
    (b) that presentation is consistent with the boards' tentative decision to present separately the right-of-use asset (leased asset) from owned assets in the SFP - that is, it highlights for financial statement users the liabilities that relate to specific right-of-use assets.[1]

[1] A decision to require the separate presentation of a lease liability from other financial liabilities in the SFP is also consistent with the boards' tentative decisions on disaggregation reached in the context of the FSP project.

Presentation of the right-of-use asset in the statement of financial position

Approaches to present the right-of-use asset

20. At their October 2009 joint meeting, the boards tentatively decided that a lease contract has created a new right (a right-of-use), which is an intangible asset. Consistent with that decision, the right-of-use asset could be presented as an intangible asset.

21. The staff think that presentation as an intangible asset would not provide users with useful information, for example, the nature of the underlying asset, the productive capacity of a business or information about how the lessee uses the leased asset.

22. Therefore, the staff considered presenting the right-of-use asset according to how the underlying asset is used. Under this approach, a lease of a motor vehicle would be presented adjacent to other motor vehicles.

23. The staff note the following advantages of basing presentation on how the underlying asset is used:

    (a) It provides users of financial statements with information about how the underlying asset is used that could be lost if the right-of-use asset is presented as an intangible asset. For example, some rights to use may be of property, whereas other rights to use may be of equipment.

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

24. The majority of respondents agreed with the boards' tentative decision to present the right-of-use asset in the SFP based on the nature of the underlying asset. Those respondents state that the nature of future economic benefits the entity will receive from the leased asset during the lease term is consistent with the future economic benefits derived from an equivalent owned asset.

25. Several of those respondents note that presenting right-of-use assets as intangible assets is misleading because the assets are not the same as other

intangible assets such as distribution rights or customer lists. They added that if the boards require that the right-of-use asset is to be presented as an intangible asset, further disclosure is necessary to explain the nature of the underlying assets.

Staff recommendation

26. The staff recommend basing the presentation of a right-of-use asset on how the underlying asset is used because:

    (a) it provides users with information about the nature of the leased asset.

    (b) it is consistent with the way in which the lessee uses the right-of-use asset in its normal course of business.

27. The staff also recommend that an entity should be required to present separately a right-of-use asset from other assets on the SFP because that presentation provides users of financial statements with information that is important to understand that a right-of-use asset is inherently different from an owned asset. For example, an entity may have greater financial flexibility with the right-of-use asset (eg the entity can easily choose to replace the right-of-use asset with a new and/or better right-of-use asset at the end of the lease term). On the other hand, a lessee may assume greater risk by acquiring a right-to-use asset (rather than owning an asset outright) because, for example, the lessee may need to replace the right-of-use asset at the end of the lease term but may not be able to secure a favourable rate.

Presentation in the statement of comprehensive Income

28. In the Leases DP, the boards noted that presentation in the SFP of the right-of-use asset and the obligation to pay rentals arising in a lease contract should determine presentation in the SCI. Consequently, the reduction in the carrying amount of the right-of-use asset should be presented as amortisation. The reduction in the obligation to pay rentals should be presented as interest expense in the SCI.

29. The staff think that both amortisation expense and interest expense related to the right-of-use asset and the obligation to pay rentals, respectively should be separately distinguishable from other amortisation expense and other interest expense presented in the SCI. That separate presentation highlights to financial statement users expenses that relate to lease contracts. Analyst participants in the FSP field test noted that transparency of the related interest expense is important.

30. The staff also note that a right to use an underlying asset obtained from a lease is different from outright ownership of the underlying asset. Consequently, it is important to distinguish between expenses that relate to leased assets and expenses that relate to owned assets.

31. Therefore, the staff recommend that both amortisation expense and interest expense that arise from lease contracts should be presented separately from other amortisation expense and interest expense presented either in the SCI or in the notes to financial statements.

32. Separate presentation enables users to better understand lease contracts, and disclosures would be sufficient to allow users to determine how much of expenses relate to leases.

Presentation in the statement of cash flows

33. Under the proposed lessee accounting model, the lessee is viewed as acquiring a right-of-use asset by obtaining financing from the lessor. As a result, rentals paid under this model include both (a) interest payments and (b) repayments of amounts borrowed. Requiring rentals paid under a lease to be split into interest payments and repayments of amounts borrowed would be consistent with the way other repayments of obligations are treated in the existing cash flow standards.

34. Both IAS 7 and Topic 230, *Statement of Cash Flows,* of the *FASB Accounting Standards Codification*™ require cash flows to be classified as operating, investing or financing. Under both standards, cash repayments of amounts

borrowed are classified as financing activities. IAS 7 permits interest paid to be classified as operating, investing or financing. However, Topic 230 requires interest paid to be classified as an operating cash flow if using an indirect method.

35. The staff think that presentation in the SFP of the obligation to pay rentals should determine presentation in the SCF. That is, both cash repayments of amounts borrowed and interest paid should be classified as financing activities in the SCF because both components arise from the lease liability, which is incurred as part of a financing activity to acquire a right-of-use asset over a specified lease term.

Question 1
The staff recommend that: a. the lessee's obligation to pay rentals should be presented separately on the face of the statement of financial position; b. the lessee's right-of-use asset should be presented separately on the face of the statement of financial position on the basis of how the underlying asset is used; c. both amortisation and interest expense arising in lease contracts should be separated from other amortisation expense and other interest expense either on the face of the statement of comprehensive income or in the notes to financial statements; and d. both cash repayments of amounts borrowed and interest payments arising in lease contracts should be classified as financing activities in the statement of cash flows. Do the boards agree?

Presentation of lease components in accordance with the boards' proposals for financial statement presentation

36. In October 2008 the boards published a joint DP *Preliminary Views on Financial Statement Presentation*. Currently, the boards are reconsidering its proposals in that project with a view to publishing an FSP ED in April 2010.

37. At the October 2009 joint meeting, the boards tentatively decided that the **business** section of the financial statements should have two defined categories, operating and investing. Business activities that are part of a reporting entity's

day-to-day business activities (and the business activity generates revenue through a process that requires the interrelated use of the net resources of the entity) should be presented in the operating category. The investing category includes business activities that generate non-revenue income (and no significant synergies are created from combining assets).

38. The **financing** section of the financial statements is defined to include items that are part of an entity's activities to obtain (or repay) capital. The financing section provides transparency about an entity's capital structure and the financing activities the entity engages. To make transparent its capital structure, an entity groups its financing activities into two categories that reveal how related resources and claims are used to provide capital to the entity, debt and equity.

39. The boards proposed that the debt category should include liabilities in which the function of the liability is a borrowing arrangement entered into for the purpose of obtaining (or repaying) capital. The borrowing arrangement is usually transacted on an arm's-length basis on market terms.

40. At the December 2009 joint meeting, the boards tentatively decided to:

    (a) require an entity to apply the cohesiveness principle at the category level across the financial statements;

    (b) indicate that, generally, an entity will classify items in the financial statements by reference to how the related assets and liabilities are classified on the SFP; and

    (c) add a sub-category to the operating category in the SFP labeled *financing arising from operating activities.*

41. At the February 2010 joint meeting, the boards tentatively defined the *financing arising from operating activities* sub-category to include items that:

    (a) are **not** entered into for the primary purpose of obtaining (or repaying) capital;

    (b) are initially long-term; and

(c) have a time value of money component that is evidenced by either interest or an accretion of the liability due to the passage of time.

42. Several respondents to the Leases DP commented that the boards' presentation decisions in the leases project should be consistent with the FSP project.

Proposed presentation of lease components in the financial statements

Right-of-use asset

43. Under the proposed FSP model, the right-of-use asset would be treated as a business asset and would be presented in the business section of the SFP. In accordance with the proposed definitions for the operating category and the investing category, the staff think that:

(a) a right-of-use-asset meets the definition of an item that would ordinarily be presented in the operating category; and

(b) for IFRS preparers only, a right-of-use asset classified as investment property held by the lessee would be presented in the investing category.

44. Application of the cohesiveness principle at the category level results in the classification of the amortisation of the right-of-use asset as either an operating expense or an investing expense in the statement of comprehensive income.

Obligation to pay rentals

45. At the Joint International Group on Financial Statement Presentation and Financial Institutions Advisory Group meeting in February 2010, one member specifically questioned where the lease obligation should be presented in the SFP (eg in the debt category of the financing section or in the financing arising from operating activities sub-category in the operating category). The member commented that the FSP ED should be specific about where that obligation is to be presented and the decision should be applied consistently in practice.

46. Consequently, under the proposed FSP model, the staff considered three possible approaches to presenting the lease liability in the SFP:

(a) Approach 1: present the lease liability in the debt category of the financing section;

(b) Approach 2: present the lease liability in the *financing arising from operating activities* sub-category in the operating category of the business section; and

(c) Approach 3: present some lease liabilities in the debt category of the financing section and other lease liabilities in the *financing arising from operating activities* sub-category in the operating category of the business section.

Staff analysis and recommendation

47. Approach 3 acknowledges that all lease liabilities are not identical. For example, some lease liabilities are very similar to debt (ie they function as a substitute for a traditional borrowing arrangement) while others are not (eg lease liabilities include amounts payable in an optional period and/or under contingent rental arrangements). Therefore, approach 3 differentiates presentation for different lease liabilities.

48. The staff think that approach 3 would add complexity to the proposed new leases requirements because guidance on differentiating liabilities would have to be developed. Therefore, it would introduce subjectivity and reduce comparability in the financial statements.

49. Some view presenting the lease liability in the debt category of the financing section (Approach 1) as conceptually consistent with the proposed lessee accounting model. The proposed right-of-use model treats all leases as a lessee acquiring a right-of-use asset by obtaining financing from the lessor. Therefore, the lease liability effectively functions as a note written to finance the purchase of the right-of-use asset. Some also think that the instalment purchase of a right-of-use asset should be no different from the instalment purchase of a building, which is treated as debt.

50. Approach 1 is consistent with the feedback received from analyst participants in the FSP field test. In the recast financial statements provided for review, analyst

participants did not agree on the classification of several other items in the operating category, primarily lease liabilities and interest on lease liabilities. Many analysts think all interest bearing debt should be classified in the financing section, not split between operating, investing, and financing.

51. However, under approach 1, the assets and liabilities arising in a lease contract would be presented in a different category and section in the financial statements. In many cases, a right-of-use asset would be presented in the operating category of the business section and an obligation to pay rentals would be presented in the debt category of the financing section.

52. If the right-of-use asset is presented so far apart from its related obligation, the staff think that it would impair understanding of lease transactions. Presenting the right-of-use asset and the obligation in the same category on the SFP provides users with a more decision-useful, cohesive picture of an entity's leasing activities than if the obligation is classified as debt in the financing section of the SFP. Putting the obligation in the *financing arising from operating activities* sub-category preserves the link between the right-of-use asset and its related obligation (Approach 2).

53. Further, the staff think that presenting <u>all</u> lease liabilities in the debt category of the financing section and applying the cohesiveness principle to that decision will result in related cash flows in the financing section of the SCF that some view as operating cash flows. Consequently, Approach 1 may provide financial statement users that view those cash payments to be operating cash flows with a less useful SCF.

54. The staff think that the obligation to pay rentals meets the definition of an item to be included in the *financing arising from operating activities* sub-category in the operating category of the business section in the SFP (Approach 2). Presenting the lease liability in that sub-category characterises the liability as financing in nature but still keeps the obligation close to the associated right-of-use asset. Further, this classification of the lease liability allows financial statement users to include such 'debt' in leverage ratios or as part of capital

employed while the related cash flows are included in an operating cash flow measure.

55. Applying the cohesiveness principle results in the classification of the associated interest expense as financing costs from operating obligations in the operating category in the SCI. That cost is shown below in the operating profit and loss subtotal, but included in the operating income as follows.

Operating income before net financing expenses arising from operating activities	**425,770**	**354,390**
Costs of financing from operating obligations.	(21,050)	(20,000)
Total Operating Income	**404,720**	**334,390**

56. The cash rental payments of the lease obligation would be presented in the operating category in the SCF because that statement does not include the sub-category. For IFRS preparers only, cash flows related to investment property held by the lessee would be presented in the investing category.

Question 2

The staff recommend that the presentation of leases should be consistent with the proposed presentation model in the financial statement presentation project. That is:

a. the right-of-use asset as an operating asset in the business section of the statement of financial position;

b. the amortisation of the right-of-use asset as an operating expense in the statement of comprehensive income;

c. the obligation to pay rentals as a liability in the financing arising from operating activities sub-category in the operating category of the business section in the statement of financial position;

d. the interest expense on the obligation to pay rentals as financing costs from operating obligations in the operating category of the business section in the statement of comprehensive income; and

e. cash rental payments in the operating category of the business section in the statement of cash flows.

Do the boards agree?