Staff Paper	**IASB/FASB Meeting** **Week commencing October 17, 2011**	IASB Agenda reference **2C**
	IASB/FASB Education Sessions **Week commencing October 10, 2011**	FASB Agenda reference **207**

Contact(s)			
	Nick Cappiello	ntcappiello@fasb.org	+1 203 956 5338
	Patrina Buchanan	pbuchanan@iasb.org	+44 0 20 7246 6468
	Danielle Zeyher	dtzeyher@fasb.org	+1 203 956 5265
	Taylor Paul	tjpaul@fasb.org	+1 203 956 5263

Project **Leases**

Topic **Presentation: Lessor Statement of Comprehensive Income**

Objective

1. The objective of this paper is to discuss the presentation of amounts recognized by the lessor in the statement of comprehensive income (SCI). A lessor will present interest income resulting from the discount on the lease receivable, accretion of the residual asset and amortization of initial direct costs recognized in the lessor's receivable.

Issues

2. The staff has identified the following issues for the Boards to consider with regards to presentation by the lessor in the SCI:
   - (a) accretion of the residual asset
   - (b) presentation of revenue and expense
   - (c) disaggregation of revenue and expense
   - (d) amortization of initial direct costs
3. The staff thinks the presentation of interest income that results from the discounting of future lease payments and imputing interest on the lease

receivable over the term of the lease is understood by users and in line with current IFRSs and U.S. GAAP.

Accretion of the residual asset

Background

4. At the July 2011, joint meeting the Boards tentatively decided that the residual asset recognized by the lessor should be accreted over the lease term.

5. Paragraph 7(d) of Agenda Paper 5G/Board Memo 193 discussed the lessor accounting model voted on by the Boards at that meeting and recommended an approach that would "recognize interest income on the lease receivable and residual asset over the lease term". However, the Boards did not specifically vote on the presentation of those income items.

Staff analysis

Interest income vs. lease income

6. Both the interest on the lease receivable and the accretion of the residual asset has been illustrated in previous Board memos as 'interest income'.

7. Some staff members think that the accretion of the residual asset should be presented in the SCI (and in the notes) as interest income for the following reasons:

   (a) The staff received feedback on the 2010 Exposure Draft (ED) from car and equipment lessor constituents that when they lease an asset, they are charging the lessee a finance cost on the entire asset, not just on the receivable. In other words, embedded in the price of the lease is a charge for the financing of the entire asset, not just the "right-of-use" piece. Thus, the entire asset is effectively being financed and the accretion on the residual asset is best reflected as interest income.

   (b) Under current IFRSs and U.S. GAAP, the residual asset is embedded in the total lease asset when the lease is a finance/capital lease. In that situation, the accretion of the residual asset is reported as interest/finance income.

8. Some staff members, however, do not think that the accretion of the residual asset should be presented as interest income. Those staff members think that it may be more appropriate to present the accretion as lease income:

   (a) The presentation of accretion of the residual asset as interest under current U.S. GAAP or IFRSs is insignificant to the presentation of total income recognized, as interest on the accretion of the residual asset today is relatively insignificant to total income recognized from the lease. This is because the residual asset, for current finance/capital leases, represents a much smaller value than is possible under the proposed lessor accounting.

   (b) Though the price of an equipment lease contract may be determined based on the cost of financing the entire asset, there are various costs embedded in the price of many goods and services and the income from the sale of those assets is presented as revenue.

   (c) It is unclear if a user of a lessor's financial statements would associate interest income from lease contracts arising from both the lease receivable and the residual asset. Interest income is generally understood as the amount of money someone charges for extending credit. The lease receivable would be understood to be the extension of credit, and it would therefore be appropriate to record interest income on the lease receivable. However, the residual asset is not an extension of credit. Therefore, it may not be appropriate to present the accretion of the residual asset as interest income.

Additional considerations

9. The disaggregation of lease income and expense is not required on the SCI under current guidance. The 2010 ED would require separation of these amounts on the SCI. However, paragraph 34 of this paper recommends either the presentation on the SCI or the disclosure in the notes of lease income and expense items.

10. If the Boards agree with the staff recommendation in paragraph 34, it is unclear whether the characterization of the accretion of the residual asset as interest income in the proposed leases standard will lead to a change in the presentation on the SCI from what is done under existing U.S. GAAP. Today, finance income from leases is generally included in the sales and revenue line on the SCI and is not generally presented separately. But, as a result of the proposed standard, the income recognized from the accretion of the residual asset and the income recorded from the subsequent accounting of the lease receivable would likely be higher than what is currently being recorded under existing leases guidance. This is because all leases would result in the recognition of a lease receivable and a residual asset. Therefore, if the total amount of income recorded for a lease becomes material to the lessor's financial statements, it could be presented separately.

11. If the interest and accretion is not separately presented on the SCI, the characterization of the income for presentation purposes (e.g., interest income versus lease income) will impact how the income is disclosed in the notes. In other words, if the income is not separately identified between the income on the receivable and the income from the accretion of the residual asset in the SCI, what these income items are called in the notes will be impacted by the decision to present the accretion as interest.

12. Additionally, the staff notes that cash received for interest is required to be presented or disclosed under Topic 230 and IAS 7. Therefore, the amount of interest on the lease receivable that is included in the lease payment is currently required to be disclosed. A consequence of presenting the accretion of the residual asset as interest income is that the lessor will also have to include the amount of the lease payment that is attributable to the interest (accretion) on the residual in its interest paid disclosure.

Feedback from outreach

13. The staff reached out and received feedback from several financial institution lessors regarding the presentation of the accretion of the residual asset in the financial statements. Net interest income is a figure that gets significant attention by users, and therefore the staff wanted to understand whether it

would be appropriate to include the accretion of the residual asset within net interest income. Those financial institutions were in favor of the accretion of the residual asset reported as interest income. They said that the goal is to achieve a return on the total amount financed in the form of interest.

14. The staff has also reached out to users of financial statements. Most users do not think of the accretion of the residual asset as interest income. They think that presentation of the accretion of the residual asset as such in the SCI would be confusing.

15. One user that was not opposed to the accretion being presented as interest income noted that companies that have significant leasing operations will include interest income from leases with revenue, and therefore was not troubled by the presentation of the accretion of the residual asset as interest income. That user also thought that the presentation of the accretion as interest income demonstrated that lessors generate value from the entire asset during the lease term.

16. Some members of the Leases Joint Working Group indicated that they do not agree with the characterization of the accretion of the residual asset as interest income, because that would not reflect the economics of some lease transactions, for example, when the lease is for a small portion of the underlying asset's economic life. That is because they do not think of those decisions as lease/buy decisions and they also recognize that the accretion represents the various income and expense items. Furthermore, the pricing of those leases are generally not based on the financing of the underlying asset. Rather, the pricing of these leases is dependent on factors such as market rates.

Staff recommendation

17. Some staff members recommend that the accretion of the residual asset be presented as interest income, as they think such presentation appropriately reflects the economics of the transactions and how they are priced. Other staff members recommend that the accretion be presented as lease income, as they

do not think that the accretion of the residual asset is interest income, and that presenting it as such would be confusing to the users of financial statements.

Question 1
Do the Boards think that the accretion of the residual asset should be presented as interest income or as lease income?

Presentation of revenue and expense

18. Paragraph 61 of the ED states:

> A lessor shall present lease income and lease expense in the income statement either in separate line items or net in a single line item so that the lessor provides information that reflects the lessor's business model. For example:
>
> (a) if a lessor's business model uses leases as an alternative means of realizing value from the goods it would otherwise sell, the lessor shall present lease income and lease expense in separate line items. Many manufacturers and dealers regard the lease of an asset as equivalent to selling the asset. Those lessors would present revenue and cost of sales so that income and expenses from sold and leased items are presented consistently.
>
> (b) if a lessor's business model uses leases for the purposes of providing finance, the lessor would present lease income and lease expense net in a single line item.

Feedback received

19. One respondent to the ED objected to the net presentation of lease income and lease expense because "gross presentation conveys a message to users about the magnitude of an entities (sic) …lessor activities." (CL #780)

20. Though the responses on this issue were limited, the majority of respondents did not object to the ability for an entity to present its revenue and expense gross or net. However, the issues that were raised related to the difficulties in applying the business model approach.

21. One respondent states:

> "We think that this sometimes may cause difficulties. If, for example, a lessor s business model uses leases both as means of realizing value from the goods it would otherwise sell and also for

> the purpose of providing finance, how should this be presented in the statement of comprehensive income?" (CL# 200)

22. Another respondent suggests:

> "… a simpler way of determining whether amounts should be presented gross or net would be to determine based upon a lessor s involvement in the lease at lease commencement whether revenue and expense should be recorded at lease commencement. For example, in many finance lease transactions the lessor does not take delivery of the asset at lease commencement. The asset goes directly from the manufacturer to the lessee. In these cases the lessor is an agent at that point in the transaction and gross recognition of lease revenue and expense would be inappropriate as well as being unnecessary. If the lessor has possession of the asset, then it would be functioning as a principal and should record revenue and expense. This approach would be consistent with the revenue recognition project."(CL# 180)

Staff analysis

23. The staff notes that the presentation guidance in the ED did not contemplate the presentation of income and expense for leases that would have been accounted for under the performance obligation approach.

24. The staff thinks that presentation based on the lessor's business model will add to the comparability between entities. For an entity that leases assets that another entity sells, gross presentation would allow a user to compare the two entities.

25. The staff thinks that a finance entity that extends financing through loans versus through leases would be most comparable when the revenue and expense from the lease transaction is shown net.

26. The staff thinks that the business model approach to determining when to show income gross or net would accommodate instances where an entity both leases its own goods and provides financing. Furthermore, the staff thinks that the lessor's involvement with and physical possession of the underlying asset are aspects of an entity that should be considered to determine presentation based on business model.

Staff recommendation

27. The staff recommends that the Boards retain the gross or net presentation guidance based on business model as stated in paragraph 61 of the 2010 ED.

Question 2
Do the Boards agree to retain the gross or net presentation guidance based on business model, as stated in paragraph 61 of the ED?

Disaggregation of revenue and expense

28. Paragraphs 61 and 62 require a lessor, under the derecognition approach to present on the SCI:

    (a) lease income and lease expense either in separate line items or net in a single line item

    (b) interest income from the lease receivable separate from other interest income.

Feedback received

29. The majority of respondents to the ED thought that it is adequate to disclose income and expenses from leasing activities rather than presenting those amounts as separate lines in the SCI.

30. Several respondents stated that separate presentation on the SCI does not occur under existing IFRSs and U.S. GAAP and that disclosure is adequate. Respondents also highlight that presentation should be determined based on IAS 1, materiality or management judgment.

31. One respondent thought that always presenting lease income and expense on the SCI could over-emphasize an entity's leasing activities.

Staff analysis and recommendation

32. The Boards tentatively decided that lessees can present on the SCI or disclose in the notes its various lease expenses. The Boards further decided that those

expenses should be disclosed in a single table in the notes to the financial statements.

33. The staff thinks that it is not appropriate in all circumstances that a lessor present line items for income and expense from leasing activities separate from other income and expense on the SCI. The staff thinks that disclosure of the income and expenses from leases would be sufficient. The staff also thinks that the decision to have a lessor present on the SCI or disclose in the notes its lease income and expense would be consistent with the Boards' decisions on lessees.

34. Therefore, the staff recommends that the lessor's income and expense from lease transactions be separately presented on the SCI or disclosed in the notes to the financial statements.

Question 3
Do the Boards agree that the lessor's income and expense from lease transaction be separately presented on the SCI or disclosed in the notes to the financial statements?

Amortization of initial direct costs

Background

35. During the March 2011 joint board meeting, the Boards decided that initial direct costs should be added to the amount recognized in the lessor's lease receivable. The staff provided analysis about and the Board discussed the accounting for initial direct costs by a lessor in Agenda paper 11A/Board memo 145 *Initial Direct Costs*. However, that paper did not discuss the presentation of the amortization of such initial direct costs.

Staff analysis

36. The staff notes that the presentation of the amortization of the initial direct costs recognized in a lessor's receivable is limited by the decisions made at the March 2011 joint meeting. That is, the initial direct costs will be recognized in net income as an adjustment to the effective yield over the lease

term, thus affecting interest income recognized over the lease term on the lease receivable. This accounting treatment is consistent with that of loan origination fees for a loan receivable/financial asset, per the Classification and Measurement subset of the FASB's *Accounting for Financial Instruments* project and IFRS 9, *Financial Instruments* (i.e., paragraphs AG5-AG8 in IAS 39).

37. Because of the Boards' decision, the staff thinks that the only approach for the presentation in the SCI of the amortization of the initial direct costs recognized in the lessor's receivable as an offset of interest income on the receivable.

38. The staff notes that the presentation of the amortization of initial direct costs is constrained by the Boards' decision on the accounting for initial direct costs. If the Boards disagree with the staff's conclusion in paragraph 37, the staff thinks it necessary for the Boards to revisit their decision to recognize initial direct costs in the lessor's lease receivable.

Question 4
Do the Boards agree with the staff conclusion as to presentation in the SCI of the amortization of initial direct costs recognized in the lessor's lease receivable?