| Staff Paper | IASB/FASB Meeting<br>Week commencing September 19, 2011 | IASB Agenda reference | **2C** |
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| | **IASB/FASB Education Sessions<br>Week commencing September 5, 2011** | FASB Agenda reference | **199** |


| Contact(s) | **Nick Cappiello** | ntcappiello@fasb.org | +1 203 956 5338 |
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| | **Danielle Zeyher** | dtzeyher@fasb.org | + 1 203 956 5265 |
| | **Patrina Buchanan** | pbuchanan@ifrs.org | +44 207 246 6468 |


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| Project | **Leases** |
| Topic | **Leases: Lessor Statement of Cash Flows** |

## Objective

1. The objective of this paper is to discuss the classification of cash received for lease payments by a lessor in the statement of cash flows (SCF).

## Summary of Proposals in the Leases Exposure Draft (ED)

2. Paragraph 63 of the ED states the following for lessors applying the derecognition approach:

> A lessor shall classify the cash receipts from lease payments as operating activities in the statement of cash flows. If the lessor:
>
> (a) applies the direct method, it shall present the cash receipts from lease payments separately from other cash flows from operating activities.
>
> (b) applies the indirect method, it shall present changes in the right to receive lease payments separately from the changes in other operating receivables.

## Issues

3. The staff thinks the primary issue concerning the presentation of amounts in the SCF is whether the receipt of a lease payment is an operating cash flow or an investing cash flow. If the Boards decide that the payment received related to the right to receive lease payments is an investing cash flow, then

they will have to make decisions about the classification of cash receipts from interest (paragraphs 40-41), variable lease payments not included in the lease receivable (paragraphs 42-44), and short-term leases (Paragraph 45).

***Feedback***

4. A number of respondents to the ED noted that the creation of a lease arrangement in exchange for the right to use an asset is akin to the issuance of a loan. Those respondents said that the requirement to present cash inflows from lease payments as operating activities is inconsistent with presenting cash inflows for loans receivable as investing activities (under IAS 7 loans made by financial institutions are not investing cash flows – See paragraph 13 of this memo). One respondent states:

> [W]e do not agree with the requirement for a lessor under the derecognition approach to classify the entire lease payment received as operating cash inflows. In effect, lessors under the derecognition approach will be classifying receipt of principal payments as operating cash inflows. Lenders classify collections of principal as investing cash inflows and we cannot understand why lessors' cash inflows under the derecognition approach should be treated any differently than the cash inflows to a lender under a debt arrangement. (CL #66)

5. One respondent thinks that different presentation of cash inflows for leases is appropriate based on the type of reporting entity. The respondent states:

> We believe the current treatment within investing activities should be retained for financial services companies. Direct transactions with customers should be classified within operating activities; however, a financial intermediary should be allowed to classify the associated lease cash flows in a similar manner to those related to a loan, which are typically classified in cash flows from investing activities. (CL#219)

6. However, some respondents view the use of the lease as revenue generating activities in exchange for assets produced as part of their primary business activities. Therefore, some respondents view the cash collected as akin to instalment payments on a sale and think that the cash flows from the collection of lease payments are best presented as operating cash flows.

***Staff analysis and alternatives***

7. The staff notes that the ED was originally drafted with the view that the *Financial Statement Presentation* project would have redefined the categories of the SCF (and all financial statements) as well as provided guidance as to the categorization of the activities an entity engages in.

8. The basis for conclusions in the ED states that in the boards' view, lease income represents the lessor's income from operating activities and, therefore, the cash flows arising from the right to receive lease payments and the interest income from leases should be classified as operating cash flows.

9. Paragraph 14 of IAS 7, *Statement of Cash Flows*, gives several examples of operating cash flows, such as:

   (a) Cash receipts for the sale of goods and the rendering of services

   (b) Cash receipts from royalties, fees, commissions, and other revenues

   (c) The cash receipt of rents of assets held for rental to others

10. Paragraph 230-10-45-16(a) of the Codification states that cash receipts from the sales of goods and services, including receipts from the collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales, are operating cash flows.

11. Paragraph 16 of IAS 7 states that cash outflows reported in the investing section of the SCF must result in recognized assets on the statement of financial position (SFP). There is no similar requirement regarding cash inflows being the result of the sale or settlement of a recognized asset. However, the list of examples of investing cash inflows given in paragraph 16 is consistent with the sale or settlement of the assets recognized as the result of an investing cash outflow.

12. The examples of cash inflows given in paragraph 230-10-45-12 of the Codification similarly provide examples of the sale and settlement of items for which cash outflows for the purchase of the assets were presented as investing cash flows.

13. The staff notes there is a difference between IFRS and U.S. GAAP on the classification of the cash flows associated with loans made to other parties by

financial institutions. Under U.S. GAAP, the issuance and collection or sale of loans are investing activities, regardless of the type of entity. Paragraphs 16(e) and 16(f) of IAS 7 indicate that the issuance and collection or sale of loans would not be an investing activity if the issuer of the loans is a financial institution.

14. Additionally, the staff notes that for the lessee, the cash flows associated with the principal lease payments are classified as a financing. One may view that if a financing exists for the lessee, the lessor has, in effect, provided cash that was used to purchase the right to use the asset. That is, the lessor has issued a loan and has thus given rise to an investing activity on the part of the lessor.

15. Based on comment letter feedback, existing requirements in both IFRSs and US GAAP and the preliminary decisions made about the lessee SCF, the staff asks the boards to consider the following approaches to classifying the cash inflows related to leases by lessors:

    (a) Approach A - Classify all cash inflows as operating activities.

    (b) Approach B – Classify all cash inflows as investing activities.

    (c) Approach C - Classify all cash inflows as operating activities unless:

        (i) The entity makes an up-front cash payment for legal title to an asset.

        (ii) The purchase of title to the asset is directly linked to that entity becoming the lessor of the asset.

        (iii) That payment to purchase the asset (outflow) is an investing activity.

    If all of these conditions are met, the inflows should be classified as investing activities.

16. When considering the above alternatives, the staff considered two types of lease transactions. The first is a transaction in which an entity manufactures the item and subsequently leases it. The second is a transaction in which a bank (or any financial institution) acquires an asset subject to a lease agreement.

17. For an entity that leases the equipment it manufactures, the cash flows associated with the manufacture of that equipment (labor costs, materials costs, etc) are predominantly operating cash outflows.

18. However, for a financial services entity that purchases an asset that is to be leased, the cash outflow (the purchase of the asset to be leased) appears to be consistent with what current SCF guidance would classify as an investing activity.

*Approach A - Classify all cash inflows as operating activities*

19. Approach A is consistent with the guidance in the ED that requires all cash receipts from lease payments to be classified as operating activities in the SCF. The basis for this decision is that because leasing activities are the operating activities of the lessor, the cash flows should be operating as well. However, as demonstrated in paragraph 18 of this memo, the acquisition of a leased asset may be classified as an investing activity.

20. Additionally, the scenario demonstrated in paragraph 18 of this memo would result in an imbalance in the SCF for the inflows (reported in operating) and the outflows (reported in investing) that are related to the same investment. The staff notes this is not exclusive to leases, thus the focus of the redefining of the sections and categories of the SCF in the *Financial Statement Presentation* project.

21. The staff thinks this approach may also be perceived as inconsistent with how other financing transactions are treated in the SCF.

22. The staff notes benefits to classifying the cash flows as operating cash flows. Classifying all cash inflows within operating activities would be consistent with how businesses think of their leasing activities would lead to comparability across IFRSs and U.S. GAAP and across all entities for the receipt of lease payments.

23. Furthermore, classification in operating would result in the entire lease payment (interest, variable lease payments, payments on short-term leases, and payments received on the right to receive lease payments) being part of the same section in the SCF.

*Approach B - Classify all cash inflows as investing activities*

24. Approach B would be the parallel of the SCF classification decisions decided for lessees. That is, for a lessee, the boards decided that the lessee has been provided with financing of the right of use asset and therefore it would be reasonable to see the provision of that financing by the lessor as an investing activity.

25. However, as pointed out in paragraphs 9 and 10 of this paper, the activities of the manufacturer that is a lessor, including the creation of a note with a customer (US GAAP), appear to be operating activities.

26. Furthermore, the staff thinks that the classification of cash inflows from a lease as investing activities is punitive to a lessor. If a lessor enters into a transaction with a customer that results in revenue to the entity, the cash flows of that arrangement will not be part of cash flows from operating activities. However, the sale of a similar asset would be an operating cash inflow.

27. Furthermore, both IFRSs and U.S. GAAP clearly state that transactions with customers for goods and services (IFRS and U.S. GAAP) and rents (IFRS) are operating cash flows. Furthermore, as pointed out in paragraph 10 of this memo, the collection of long term notes with customers is an operating cash flow.

*Approach C – Classify cash inflows dependent on the outflows associated with the lease.*

28. Approach C would have a lessor classify all cash inflows as operating activities unless:

    (i) The entity makes an up-front cash payment for legal title to an asset.

    (ii) The purchase of title to the asset is directly linked to that entity becoming the lessor of the asset.

    (iii) That payment to purchase the asset (outflow) is an investing activity.

    If all of these conditions are met, the inflows should be classified as investing activities.

29. Approach C would result in the lessor classifying cash inflows from a lease contract consistently with other cash flows in the lease transaction. For example, banks would likely classify cash outflows for the acquisition of an asset subject to lease as an investing cash outflow. Under this approach, the corresponding cash inflows would also be reported as an investing cash inflow.

30. This approach would result in the manufacturer classifying its inflows from a lease as operating cash inflows. However, one disadvantage to this approach is that in IAS 7 the cash paid for PP&E that is held for rent and subsequent sale is an operating cash outflow. There is no similar statement in US GAAP and therefore these outflows would likely be investing. Therefore the subsequent cash inflows under this approach would not be comparable under IFRS and US GAAP.

31. The staff thinks that Approach C would result in the classification of cash flows for an entity that leases its assets as a lessor versus an entity that sells assets would be comparable. However, differences between the guidance for amounts in the SCF may in IFRSs and US GAAP may still result comparability issues

*Other approaches considered*

32. The staff also considered, classifying all cash inflows in accordance with existing cash flow guidance.

33. The staff thinks that classifying the cash inflows from a lease in accordance with existing cash flow guidance will result in comparability issues between entities reporting in IFRS or U.S. GAAP. The staff also thinks that without additional lease-specific guidance, there will be disparity in practice among similar entities reporting under the same standard. Therefore, the staff rejects this approach.

### *Staff recommendation*

34. The staff does not think that an extension of credit in and of itself, in accordance with current guidance, results in an investing cash inflow. Therefore the staff does not support Approach B.

35. Some staff members support Approach A because, in the case of a lessor whether it be a financial institution or a manufacturer, the leasing activity is part of the operations of the entity and there would be comparability of the effects of leasing cash flows across all entities.

36. Other staff members support Approach C. Those staff members think that when an entity becomes a lessor as part of a transaction in which it acquires an asset that is subject to a lease and that transaction is reported as an investing cash outflow, the SCF should reflect the subsequent inflows from the lease as investing activities (see discussions of interest, variable lease payments and short term leases in paragraphs 37-44).

| **Question 1** |
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| Do the boards agree with Approach A or Approach C? |

## Consequential decisions for those leases classified as investing cash flows

37. If the Boards classify the cash inflows of all (Approach B) or some (Approach C) leases as investing cash inflows, they will have to decide the classification of the cash flows related to:

    (a) Interest received

    (b) Gain from lease assets

    (c) Variable lease payments not included in the right to receive lease payments and sale or realization of value for the residual asset

    (d) Short-term leases for which the practical expedient is elected.

38. If the Boards decide that all or some cash inflows related to the right to receive lease payments are operating, the staff does not think there is a need to deliberate the classification of the cash flows referred to in paragraph 37 of this memo. The requirement in the ED would be sufficient; that is, classify all lease cash inflows as operating.

39. Because the ED did not include the requirement to classify cash inflows of the lessor for leases to be classified as investing cash inflows, there is little feedback in the comment letters specific to this topic. However, the staff believes feedback from lessees on those issues as well as existing SCF guidance provides a good basis for its recommendations.

***Interest received***

40. Agenda paper 5B/Board memo 188 from the July joint Board meeting details the difference between IAS 7 and Topic 230, Statement of Cash Flows, regarding interest expense. The same differences exist for interest received. That is, under IAS 7 it may be operating or investing, whereas Topic 230 requires the amount to be in operating cash flows.

41. Consistent with the Boards' decision to require that interest paid by a lessee be classified in accordance with existing IFRSs and U.S. GAAP, the staff recommends that interest received by the lessor be classified in accordance with existing IFRSs and U.S. GAAP.

| **Question 2** |
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| Do the Boards agree that the interest received by the lessor should be classified in accordance with existing IFRSs and U.S. GAAP? |

***Variable lease payments and the sale of the residual***

42. The staff thinks that a bank making a purchase of an asset that is in turn to be leased takes into account a series of future cash flows when determining the purchase price. Those cash flows (the collection of (a) principle, (b) interest, (c) and other consideration related to the asset and the ultimate sale of the residual) are all taken into account when pricing the purchase of the asset that results in investing cash outflows.

43. The staff notes that the consequence of recording the cash inflows from variable lease payments and sale of residual in investing activities will result in the adjustment to net income in the operating section of the SCF. That is, if the variable lease payment income or gain on sale of residual is recorded in net income and the cash flows are reflected in investing, there needs to be an

adjustment to net income for the variable lease payment income or the gain so as not to double count the cash flow.

44. Therefore, the staff recommends that cash inflows from variable lease payments that are not part of the lease receivable and the sale of the residual assets should be classified consistently with the cash inflows related to the lease receivable.

| **Question 3** |
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| Do the Boards agree that cash inflows from variable lease payments that are not part of the lease receivable and the sale of the residual asset should be classified consistently with the cash inflows related to the lease receivable? |

***Short-term leases for which the practical expedient is elected***

45. The staff would apply the same logic to the lessor as it did to the lessee for the classification of payments of short-term leases for which the practical expedient is elected. Because there would be receivable recognized, there would be no investing cash inflow related to an investing asset. Therefore, the staff recommends that cash inflows related to short-term leases for which the practical expedient is elected should be classified as operating cash flows.

| **Question 4** |
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| Do the Boards agree that cash inflows from short-term leases for which the practical expedient is elected should be classified as operating cash flows? |