STAFF PAPER

June 2014

REG FASB | IASB Meeting

Project	**Leases**		
Paper topic	Cash Flow Presentation		
CONTACT(S)	Kathryn Donkersley	kdonkersley@ifrs.org	+44 (0)20 7246 6970
	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0)20 7246 6468
	Danielle Zeyher	dtzeyher@fasb.org	+1 (203) 956 5265

Objective

1. The purpose of this paper is to discuss the presentation of leases in the statement of cash flows, taking into account feedback received on the proposals in the revised exposure draft on leases issued in May 2013 (2013 ED), as well as the Boards' decisions at their March 2014 joint meeting.

2. This paper is structured as follows:

    (a) Summary of staff recommendations

    (b) Background

    (c) Feedback received on the 2013 ED

    (d) Staff analysis – Lessor cash flow presentation

    (e) Staff analysis – Lessee cash flow presentation (FASB-only)

    (f) Staff analysis – Lessee cash flow presentation (IASB-only)

        (i) Overview of the proposed approaches

        (ii) Approach 1 – Retain proposals from 2013 ED

        (iii) Approach 1A – Approach 1 modified to require interest payments to be classified as financing activities

(iv) Approach 2 – Classify all lease cash outflows within operating activities

(g) Staff recommendations for lessee cash flow presentation (IASB-only)

Summary of staff recommendations

3. The staff recommend the following regarding the presentation of leases in the statement of cash flows:

(a) That the Boards retain the proposals in the 2013 ED (which are the same as the existing requirements of IFRS and U.S. GAAP) for lessors to classify cash receipts from leases within operating activities.

(b) That the FASB retain the proposals in the 2013 ED for lessees to classify:

(i) Cash payments for the principal portion of the lease liability arising from Type A leases within financing activities;

(ii) Cash payments for the interest portion of the lease liability arising from Type A leases within operating activities; and

(iii) Cash payments arising from Type B leases within operating activities.

(c) That the IASB:

(i) Require a lessee to classify all lease cash payments within operating activities; and

(ii) Require the separate disclosure of lease payments within cash flows from operating activities. This requirement would be similar to the existing requirements of IAS 7 *Statement of Cash Flows* relating to interest and taxes.

Background

Lessor accounting

4. Under existing IFRS and U.S. GAAP leases guidance, and under the proposals of the 2013 ED, a lessor classifies all cash receipts from lease arrangements within operating activities in the statement of cash flows.
5. At the March 2014 joint Board meeting, the Boards decided to retain a lessor accounting model that is similar to the existing requirements of IFRS and U.S. GAAP.

Lessee accounting

6. Under existing IFRS and U.S. GAAP leases guidance, a lessee classifies operating lease payments within operating activities in the statement of cash flows. With respect to finance/capital leases:
   (a) Under IAS 17 *Leases*, a lessee classifies principal repayments within financing activities and has a choice as to whether to classify interest payments within financing activities or operating activities.
   (b) Under Topic 840, *Leases*, a lessee classifies principal repayments within financing activities and interest payments within operating activities.
7. The 2013 ED contained proposals similar to existing guidance for cash flow statement presentation. A lessee would present cash flows arising from Type A leases in the same way as those arising from existing finance/capital leases, and cash flows arising from Type B leases in the same way as those arising from existing operating leases. The 2013 ED did not propose any specific disclosure regarding lease cash outflows, with the exception of a proposal to include a 'cash paid' line within the reconciliation of opening and closing balances of the lease liability for both Type A and Type B leases.

8. At the March 2014 joint Board meeting, the FASB and the IASB reached the following decisions with respect to the lessee accounting model:

FASB lessee accounting model

9. The FASB decided on a dual approach for lessee accounting, with lease classification being determined in accordance with the principle in existing lease requirements. Under this approach, a lessee would account for most existing capital/finance leases as Type A leases, and account for most existing operating leases as Type B leases ("FASB model").

IASB lessee accounting model

10. The IASB decided on a single approach for lessee accounting. Under this approach, a lessee would account for all leases as Type A leases ("IASB model").

Feedback received on the 2013 ED

11. The proposed presentation in a lessee's statement of cash flows was an area on which investors and analysts ("users") provided feedback.

12. Generally, users did not support the cash flow statement presentation requirements for lessees that were proposed in the 2013 ED. Most users would prefer to see a single figure for lease cash outflows appearing on the statement of cash flows. The majority of users that provided this feedback supported this lease cash outflow figure being classified within operating activities.

13. In addition, users raised the following specific concerns and suggestions with the requirements in the 2013 ED for the presentation of Type A leases in the statement of cash flows:

    (a) Some users would like the statement of cash flows to reflect lessee cash outflows in a way that is comparable to those of a financed purchase (ie buying an asset and separately financing the purchase of that asset). This would require recognising a 'day one' cash outflow within investing activities at lease commencement and a corresponding cash inflow within financing activities.

(b) Other users take the view that lease cash payments are similar in nature to capital expenditure and should be classified within investing activities in the statement of cash flows.

(c) Some users use a measure of 'free cash flow' in their analysis. 'Free cash flow' is considered to be the cash left over after deducting the cash needed for operations and for investing in assets used in an entity's operations. These users would like all lease cash outflows to be included within this 'free cash flow' measure, which would require lease cash flows to be classified within either operating or investing activities.

(d) Finally, some users are concerned about the lack of comparability under IFRS that results from a lessee having a choice as to whether to classify interest payments within operating activities or within financing activities.

Staff analysis – Lessor cash flow presentation

14. Because of the Boards' decision in the March 2014 joint Board meeting to retain a lessor accounting model that is similar to existing requirements of IFRS and U.S. GAAP, the staff recommend that the Boards also retain the existing requirement that all cash receipts from leases are classified within operating activities in the statement of cash flows of lessors. This requirement is the same as the proposal for lessor cash flow presentation in the 2013 ED. In light of the fact that no substantial feedback has been received in this area, the staff think that lessor cash flow presentation does not require any further redeliberation by the Boards.

Question 1: Lessor cash flow presentation
Question 1 – Do the Boards agree with the staff recommendation to retain the proposals in the 2013 ED (which are the same as the existing requirements of IFRS and U.S. GAAP) for lessors to classify cash receipts from leases within operating activities in the statement of cash flows?

Staff analysis – Lessee cash flow presentation (FASB-only)

15. Because a dual approach to lessee accounting has been retained by the FASB in their redeliberations, the staff think that the basis for decisions made by the FASB regarding cash flow presentation in the 2013 ED remains unchanged. Retaining the proposals in the 2013 ED under the FASB model means that:

    (a) The existing link between a lessee's income statement and cash flow statement for Type A leases would be retained by classifying repayments of the principal portion of the lease liability within financing activities and the interest on the lease liability within operating activities.

    (b) The existing link between a lessee's income statement and cash flow statement for Type B leases would be retained by classifying all cash flows within operating activities.

    (c) There will be no change in the lessee's statement of cash flows compared to the existing requirements in Topic 840. Users are generally happy with the existing cash flow presentation under the dual model.

    (d) Most lease cash outflows will be treated as operating activities because most leases will likely be Type B leases (just as most leases are operating leases under existing U.S. GAAP) rather than Type A leases. Based on feedback received from users on the 2013 ED, this presentation provides them with useful information.

16. Therefore, the staff recommend that the FASB retain the proposals in the 2013 ED with respect to lessee cash flow presentation.

Question 2: Lessee cash flow presentation (FASB-only)
Question 2 – Does the FASB agree with the staff recommendation to retain the proposals in the 2013 ED regarding lessee presentation in the statement of cash flows for Type A and Type B leases?

Staff analysis – Lessee cash flow presentation (IASB-only)

17. If the 2013 ED proposals for lessee cash flow presentation under Type A leases are retained, then application of the IASB model would result in lease cash outflows being split between principal repayments (allocated to cash flows from financing activities) and interest payments (allocated to cash flows from either financing activities or operating activities depending upon a lessee's accounting policy choice) for all leases.

18. This would represent a substantial change to the statement of cash flows compared to today for any lessee with material operating leases. This is because cash flows from operating leases are currently classified within operating activities in the statement of cash flows. Although a lessee's total cash flow in any period would not change, application of the 2013 ED cash flow proposals for Type A leases would result in improved cash flows from operating activities because lease cash outflows relating to existing operating leases would be presented within cash flows from financing activities.

19. Because of the substantial effect on a lessee's statement of cash flows as well as the feedback received from users, the staff think that it is worth considering the advantages and concerns of alternative cash flow presentation options for Type A leases.

Overview of the proposed approaches

20. All three approaches discussed in this paper start from the premise that it is not appropriate to introduce any non-cash movements or disclosures within the statement of cash flows. This is consistent with the existing requirements of IAS 7.

21. The staff acknowledge the feedback from a number of users that would support a cash flow presentation approach for leases that would result in a statement of cash flows which is comparable to that of a financed asset purchase. Such a presentation would require the 'day one' recognition of an investing cash outflow and a financing cash inflow equivalent to the cost of the right-of-use (ROU) asset. However, such an approach would require the introduction of non-cash movements within the statement of cash flows (as illustrated below), which the staff do not consider to be a viable option. The following table presents the cash flow effects of a lease under this presentation approach over the full term of the lease.

Purchase value of asset: CU100 *Interest arising: CU5*	***Financed Purchase***	***Lease***	
	Cash Flow Statement	**Cash Movements**	**Non-Cash Movements**
	CU	**CU**	**CU**
Cash flows from operating activities			
Interest payments	(5)*	(5)*	-
	(5)	(5)	-
Cash flows from investing activities			
Additions to PPE/ROU assets	(100)	-	(100)
	(100)	-	(100)
Cash flows from financing activities			
Debt arising on inception of leases	100	-	100
Cash repayments of lease liabilities	(100)	(100)	-
	-	(100)	100
Total cash flows	**(105)**	**(105)**	-

*Interest has been allocated to operating activities (under existing requirements, the 2013 ED and Approach 1 as described in this paper, a lessee can alternatively present interest within financing activities)

22. The staff note that there are a number of other investing or financing transactions for which a non-cash movement in the statement of cash flows is likely to provide useful information to users. IAS 7 specifically addresses this issue and requires that all relevant information about such transactions be disclosed elsewhere in the financial statements. In the staff's view, there is no reason why entering into a lease should result in a different treatment in the statement of cash flows to any other non-cash transaction.

23. In addition, the staff note that although there are some advantages to achieving a comparable presentation, in terms of cash flows a lease is *not* the same as a financed purchase. This is because, when an entity purchases an asset and separately finances that purchase, it would present an investing cash outflow for the purchase of the asset and a financing cash inflow relating to the financing. The staff think that to present a lease in this way in the statement of cash flows may not lead to a fair representation.

24. The staff are proposing three possible approaches for the IASB to consider with respect to the lessee cash flow statement presentation:

    (a) *Approach 1* – Proposes retaining the presentation requirements in the statement of cash flows from the 2013 ED for Type A leases. Accordingly, a lessee would present cash payments that reduce the principal element of the lease liability within financing activities in the statement of cash flows for all leases. A lessee would classify interest payments within either operating activities or financing activities based on a lessee's accounting policy choice. This is consistent with the existing requirements of IAS 7 for all payments of interest.

    (b) *Approach 1A* - Proposes requiring a lessee to classify all cash payments under a lease within financing activities in the statement of cash flows. This approach would be similar to Approach 1 but would require a lessee to classify interest payments under a lease as cash flows from financing activities. This approach would also require a lessee to present a single line item for leasing cash outflows on the statement of cash flows within financing activities.

(c) *Approach 2* – Proposes requiring a lessee to classify all cash payments under a lease within operating activities in the statement of cash flows. This approach would also require a lessee to present a single line for leasing cash outflows on the statement of cash flows within operating activities (as is currently required for cash payments of interest and tax by IAS 7).

25. The effect of the three proposed approaches over the full lease term can be exemplified as follows:

Purchase value of asset: CU100 *Interest arising: CU5*	***Financed Purchase***	***Lease***		
	Cash Flow Statement	**Approach 1**	**Approach 1A**	**Approach 2**
	CU	**CU**	**CU**	**CU**
Cash flows from operating activities				
Interest payments	(5)*	(5)*	-	(105)
	(5)	(5)	-	(105)
Cash flows from investing activities				
Cash payments to acquire PPE	(100)	-	-	-
	(100)	-	-	-
Cash flows from financing activities				
Cash proceeds from issuing borrowings	100	-	-	-
Cash repayments of borrowings	(100)	(100)	(105)	-
	-	(100)	(105)	-
Total cash flows	**(105)**	**(105)**	**(105)**	**(105)**

*Where a choice exists, interest has been allocated to operating activities

Approach 1 – Retain proposals from 2013 ED

Advantages of Approach 1

26. The main advantage of Approach 1 is that it is conceptually consistent with treating the lease liability as a financial liability (that is measured on an amortised

cost basis) under the ROU model. The Type A model depicts all leases as financing transactions, both in the income statement and in the balance sheet. This coherency and consistency between the primary statements is something that the IASB considered important in their redeliberations on the lessee accounting model in the March 2014 Board meeting. Approach 1 would result in this consistency also flowing through to the statement of cash flows because the proposed presentation is consistent with the treatment of all other repayments of financial liabilities (measured on an amortised cost basis).

27. This approach is consistent with the existing treatment of finance leases under IAS 17. This means that Approach 1 is a familiar cash flow model for both preparers and users.

Concerns about Approach 1

28. Under Approach 1, operating and investing cash flows (used by users when calculating 'free cash flow') do not include cash outflows in respect of the principal element of lease payments. They may also not include interest payments depending on the accounting policy choice made by a lessee. This means that a lessee may be generating operating cash inflows from the use of assets for which the related capital expenditure has never been included within operating or investing cash flows. This capital expenditure 'blind spot' is something that has been raised by some users as an adjustment that they would need to make to reported figures in their analyses. This is because considering operating cash flows or 'free cash flows' without including the capital expenditure needed to maintain those cash flows can give a false impression of the ability of an entity to generate cash.

29. The ROU model is based on the premise that a lease represents the purchase of a non-current, non-financial asset. Any 'normal' purchase of a non-current asset gives rise to an investing cash outflow representing the cash paid to purchase the asset, which users would then exclude from what they consider to be a lessee's 'free cash flow'. Although the timing of cash flows under a lease is different to those under a purchase, the substance is similarly that of cash outflows relating to

the right to use an asset that will ultimately contribute towards the operating activities of an entity. It is therefore arguably inconsistent that, on an aggregate basis over the course of the contract, a lessee would not classify cash outflows arising from leases within operating or investing cash flows under Approach 1.

30. Approach 1 gives a lessee an accounting policy choice regarding how interest payments are classified in the statement of cash flows. Although this approach is consistent with the existing requirements of IAS 7 for all interest payments, it limits the comparability between entities of the cash flow effects of leases.

31. Finally, Approach 1 is inconsistent with the existing approach for operating leases under IAS 17. This means that on transition, Approach 1 would give rise to a significant improvement in operating cash flows for any entity with material operating leases. This would occur because operating lease cash outflows would be relocated from operating activities to financing activities under the Type A cash flow presentation proposals of the 2013 ED. For some, it may be difficult to understand why there is such a change in amounts reported within the statement of cash flows, when the actual cash flows arising from leases have not changed – only the accounting has.

Approach 1A – Approach 1 modified to require interest payments to be classified as financing activities

Advantages of Approach 1A

32. The advantages of Approach 1A are similar to those for Approach 1. Approach 1A also has the additional advantage of improving comparability between lessees by eliminating the accounting policy choice regarding how interest payments are classified in the statement of cash flows.

33. The elimination of this accounting policy choice also means that Approach 1A comes much closer than Approach 1 to providing a single figure for lease cash outflows presented separately on the statement of cash flows. The staff note, however, that this figure would not include any cash outflows in respect of variable lease payments, short term leases, or small asset leases which would be

classified as cash flows from operating activities. It would represent only those lease payments relating to the settlement of amounts recognised as part of the lease liability on a lessee's balance sheet.

Concerns with Approach 1A

34. The disadvantages of Approach 1A are similar to those for Approach 1. In addition, Approach 1A does not permit the same choice in respect of the cash flow presentation of interest payments as the existing requirements of IAS 7. Following either Approach 1 or Approach 1A supports the view that the substance of any lease is that of a financing arrangement. A disadvantage of Approach 1A, therefore, is that for any entity which currently recognises interest payments within operating cash flows, payments of lease interest will be treated differently to interest payments in respect of any other financing arrangement.

35. As described above, Approach 1A would not completely address user feedback regarding the presentation of a single figure for lease cash outflows. This is because all cash outflows relating to the settlement of lease liabilities would be classified within financing activities, whilst any cash outflows relating to variable lease payments, short-term leases, and small asset leases would be classified within operating activities.

Approach 2 – Classify all lease cash outflows within operating activities

Advantages of Approach 2

36. Many of those that support Approach 2 do so because they consider lease cash outflows to reflect a cost that relates directly to an entity's day to day operations and as such should be reflected within operating activities. In other words, for many of those that would support Approach 2 the cash outflows during the lease term under a Type A model broadly represent the income statement charges for interest and amortisation each period.

37. Recognition of lease cash outflows within operating activities would limit the extent to which users need to adjust reported figures when they are assessing the 'free cash flow' of a lessee.

38. Approach 2 would give rise to a single figure in the statement of cash flows for lease cash outflows. This figure would be complete in the sense that it would include all cash outflows relating to leases (including variable lease payments and payments for short term and small asset leases) within operating activities. The staff note that this would require a specific presentation requirement within the statement of cash flows similar to that currently required by IAS 7 for payments of interest and tax.

39. This approach would give rise to a comparable presentation of lessee cash outflows across all entities.

40. A further advantage of Approach 2 is that it would reduce the significant change in reported cash flows from operating activities on transition that would result from the application of Approach 1 or Approach 1A. This is because this cash flow approach is similar to that for existing operating leases. The staff note that Approach 2 would however result in a decrease in operating cash flows on transition for any lessee with existing finance leases under IAS 17. This is because a lessee would classify cash outflows in respect of finance leases within cash flows from operating activities under Approach 2, whereas the lessee classifies at least some of those cash outflows as financing activities under existing requirements. However, the staff expect this effect to be less significant than the improvement in operating cash flows on transition that would occur on transition to either Approach 1 or Approach 1A. This is because there are substantially more operating leases than finance leases reported under existing guidance.

Concerns with Approach 2

41. The IASB's Type A lessee model treats all leases as the financed purchase of a ROU asset on the income statement and balance sheet. Accordingly, there is coherency between the balance sheet and income statement – a lessee recognises

interest on lease liabilities (which are financial liabilities measured on an amortised cost basis) separately from amortisation of the ROU asset. Classifying all lease cash flows within operating activities on the statement of cash flows means that this coherency does not flow through to the statement of cash flows. Some might argue that this undermines the premise that a lessee should account for all leases as the financed purchase of a ROU asset.

42. Nonetheless, the staff note that, although from a balance sheet perspective a lease *does* give an entity the same result as a financed purchase (ie control of a non-current asset and an associated financial obligation); the same is not true from a cash flow perspective. A financed purchase would give rise to a day one cash inflow from the financing arrangement and a 'day one' cash outflow relating to the asset purchase. In contrast, there are no equivalent day one cash inflows and outflows in respect of a lease. Given that the statement of cash flows must represent only actual cash flows, it is therefore not possible to reflect a lease in a way that would give the same result as purchasing an asset and separately financing that purchase. The staff think that classifying lease cash outflows within operating activities in the statement of cash flows is reflective of the fact that a lease is *not* the same as a financed purchase in terms of actual cash flows.

43. Approach 2 could give rise to a distorted view of the ratio between both operating and free cash flows and the level of balance sheet financial liabilities. Under Approach 2, both cash flow metrics are reduced by cash lease payments – ie the annual cost of servicing lease liabilities would be taken into account in determining operating and free cash flows. If this figure were to be compared to a lessee's balance sheet, it could therefore give a distorted picture about the level of operating or free cash flow available to service the financial liabilities of the lessee.

44. A further concern with Approach 2 is that in order to achieve many of the benefits for users noted above, it will be necessary to require the separate disclosure of lease payments within cash flows from operating activities. Although such a requirement would be similar to the existing requirements of IAS 7 relating to interest and taxes, it is not evident why lease payments should warrant a unique

treatment in the statement of cash flows. It is clear from the user feedback received that obtaining one figure for lease cash outflows would provide useful information. However, the same is likely to be true for other types of transactions. In saying that, the staff do not think the leases project should address general concerns related to cash flow statement presentation and should, instead, focus on the most appropriate cash flow statement presentation for leases.

Staff recommendations for lessee cash flow presentation (IASB-only)

45. The staff think that the presentation of a lease in the statement of cash flows should ideally represent both:

    (a) The operating element of a lease – i.e. cash outflows within either operating activities or investing activities, which represents cash paid to acquire an asset that is used within the operations of a lessee; and

    (b) The financing element of a lease – i.e. cash outflows within financing activities which represent the repayment of the lease liability.

46. Because a lease contains only one set of actual cash outflows, a choice must be made over whether to present the financing element inherent in the lease (Approach 1 and Approach 1A) or the operating nature of the cash outflows (Approach 2). In the staff's view, classifying lease payments within operating activities would provide more relevant and useful information to users than presenting them within financing activities. Feedback received from users indicates that presenting lease cash outflows within financing activities on the statement of cash flows would effectively remove lease cash flows from those that are often used by users in their analyses of cash generated from a lessee's operations.

47. On balance therefore, the staff recommend Approach 2, ie that a lessee should classify all lease cash outflows within operating activities in the statement of cash flows.

48. To provide the most useful information to users, the staff also recommend requiring the separate presentation of lease payments as a line item within cash flows from operating activities in the statement of cash flows. This requirement would be similar to the existing requirements of IAS 7 relating to interest and taxes. This will mean that the cash effect of leases would be visible in the statement of cash flows.

Questions 3-4: Lessee cash flow presentation (IASB-only)
Question 3 – Does the IASB agree with the staff recommendation that lessee cash flow presentation should classify all lessee cash outflows within cash flows from operating activities? If not, which approach does the IASB prefer? Question 4 – Does the IASB agree with the staff recommendation to require the separate presentation of lease payments within cash flows from operating activities on the statement of cash flows?