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STAFF PAPER

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Project	**Leases**		
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Introduction

1. The objective of this paper is to discuss presentation of the lessee's right-of-use ("ROU") asset and the liability to make lease payments ("lease liability") in a lessee's balance sheet for Type A and Type B leases. This paper should be read in conjunction with Agenda Paper 3A/FASB Memo 268, Lessee Accounting Model.

2. This paper is structured as follows:

   (a) Background.

   (b) Presentation of the ROU Asset.

   (c) Presentation of the Lease Liability.

3. The staff analysis and the staff recommendations are included within the ROU asset and the lease liability sections.

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Background

4. The 2013 ED proposed that a lessee would either present on the balance sheet or disclose in the notes all of the following:
   (a) ROU assets separately from other assets.
   (b) Lease liabilities separately from other liabilities.
   (c) ROU assets arising from Type A leases separately from ROU assets arising from Type B leases.
   (d) Lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases.
5. The 2013 ED proposed that if a lessee does not present ROU assets and lease liabilities separately on the balance sheet, then the lessee would do both of the following:
   (a) Present ROU assets (both Type A and Type B) within the same line-item as the corresponding underlying assets would be presented if they were owned.
   (b) Disclose which line-items on the balance sheet include ROU assets and lease liabilities.
6. The proposal to present ROU assets consistently with owned assets was based on reflecting the function, or utility, that the lessee obtains from having the right to use the underlying asset. The Boards concluded that presenting leased and owned assets in a similar way would be useful because a lessee often uses owned assets and leased assets for the same purpose and derives similar economic benefits from the use of owned assets and leased assets. However, the Boards wanted to provide flexibility for preparers if there were instances in which it would be useful for ROU assets to be disaggregated from other assets.
7. The 2013 ED did not prescribe how lease liabilities should be presented on the balance sheet if not presented as separate line-items. However, the Basis for Conclusions to the 2013 ED stated that the lease liability is a financial liability.

8. In addition, the Boards decided that the quantitative disclosure requirements applicable to ROU assets and lease liabilities should be presented separately for Type A and Type B leases due to the differences in accounting between Type A and Type B leases.

Presentation of the ROU Asset

Staff Analysis

9. In the 2013 ED the Boards proposed all leases, both Type A and Type B, would be presented as owned assets. After reviewing the lessee accounting model, the staff have reconsidered presentation, with a stronger emphasis on the distinction between Type A and Type B leases that arises from a dual model approach. The staff continue to think that ROU assets resulting from Type A leases should be presented in a similar way with owned assets as that presentation, for those leases, provides the most useful information to users of financial statements. Therefore, the staff think that the Boards should retain the proposals in the 2013 ED for presentation of ROU assets arising from Type A leases.

10. In regards to the ROU assets that arise from Type B leases, the staff think that a different presentation may be appropriate. As described in Agenda Paper 3A/FASB Memo 268, the rationale for Approach 3 asserts that Type B leases have a unique, or specialized, role in business that neither reflects the full transfer of a nonfinancial asset (such as purchasing an asset), nor is equivalent to a service contract. Therefore, a lessee would not need to account for ROU assets that result from Type B leases consistently with other nonfinancial assets or assets that may result from service contracts (for example, prepaid expenses). This would also be the case for balance sheet presentation. The staff think that this conclusion applies equally regardless of whether the Boards were to adopt Approach 1A, Approach 2, or Approach 3 with respect to the lessee accounting model.

11. Although the staff acknowledge that some constituents think that presenting Type B ROU assets as if the lessee owned the underlying asset is appropriate, others do not. After considering all the input and the different lessee accounting model approaches that are being proposed in Agenda Paper 3A/FASB Memo 268, the staff think that

Type B ROU assets may not be best presented in the same manner as other nonfinancial assets. The staff think that separate presentation of Type B ROU assets is most consistent with the unique accounting for Type B ROU assets and the rationale for that unique accounting outlined above and in Agenda Paper 3A/FASB Memo 268.

12. The staff acknowledge that one disadvantage to *not* presenting Type B ROU assets consistently with other nonfinancial assets would be that it would not provide some users with all of the information that they need on the face of the financial statements. In particular, it would not do so for those users that aim to compare a company that leases its assets with a company that purchases its assets. However, the staff note that the footnotes would provide that necessary information, including the line-item in which ROU assets are included and the amount of Type B ROU assets.

13. Some staff think that, given the rationale expressed in Agenda Paper 3A/FASB Memo 268 for a dual lessee model (that is, that the rights and obligations resulting from a Type B lease are substantially different from those conveyed by ownership of the underlying asset or those conveyed in a Type A lease), the Boards should, explicitly *prohibit* presentation of Type B ROU assets in the same line-item as Type A ROU assets so as to ensure those differences are reflected in the balance sheet as well as the income statement.

14. Other staff think that the Boards should not prescribe a particular presentation for Type B ROU assets that are not presented separately on the balance sheet to provide preparers flexibility to determine the appropriate presentation. Under either approach, the staff think that it is important to require that the lessee disclose the balance sheet line-item in which the ROU assets are included and the amount of Type B ROU assets recognized.

Staff Recommendation

15. Based on the analysis above, the staff recommend that the Boards:

    (a) Confirm that a lessee should present Type A and Type B ROU assets separately (from each other and from other items) on the balance sheet or in the notes. If a lessee does not present Type A and Type B ROU assets

separately on the balance sheet, a lessee should disclose in the notes the line-items in which each type of ROU asset is included.

(b) Confirm that a lessee should present Type A ROU assets in the same line-item as if the underlying asset were owned, if not presented separately on the balance sheet. The staff think that this requirement would remain appropriate for Type A ROU assets because, under either Approach 2 or Approach 3, Type A leases would be considered to create ROU assets that are substantially similar to other nonfinancial assets.

(c) Not prescribe a particular presentation for Type B ROU assets that are not presented separately on the balance sheet. Because the staff think that Type B ROU assets are dissimilar from other nonfinancial assets, there is no need for the Boards to prescribe a particular presentation for these assets, if not presented separately on the balance sheet. The Boards should however mandate that a lessee's presentation of its Type B ROU assets should be rational and consistent for similar leases.

Note: Some staff think that the Boards should also explicitly *prohibit* presentation of Type B ROU assets in the same line-item as Type A ROU assets.

16. The staff think that the updated ROU asset presentation guidance would be similar to the following:

(a) A lessee shall either present on the balance sheet or disclose in the notes both of the following:

(i) ROU assets separately from other assets.

(ii) ROU assets arising from Type A leases separately from ROU assets arising from Type B leases.

(b) If a lessee does not present ROU assets separately on the balance sheet, the lessee shall present:

(i) ROU assets arising from Type A leases within the same line-item as the corresponding underlying assets would be

presented if they were owned and disclose which line-item(s) on the balance sheet include ROU assets arising from Type A leases.

(ii) ROU assets arising from Type B leases in a consistent and rational manner and disclose which line-item(s) on the balance sheet includes ROU assets arising from Type B leases.

Question 1
Do the Boards agree with the staff recommendations with respect to presentation of ROU assets?

Presentation of the Lease Liability

Staff Analysis

17. In the 2013 ED, the Boards did not specify how a lessee should present lease liabilities on the balance sheet, or how a lessee should characterize lease liabilities (that is, as debt-like or non-debt like, or operating-type, liabilities). However, the Basis for Conclusions to the 2013 ED stated that the lease liability is a financial liability. The staff continue to think that lease liabilities are financial in nature and meet the definition of financial liabilities under both U.S. GAAP and IFRS, based on the lessee's obligation to make lease payments to the lessor. However, some feedback has suggested that the lease liability, especially for Type B leases, could be appropriately characterized as an operating liability, based on its treatment in bankruptcy and based on existing guidance in U.S. GAAP for other liabilities that are considered operating liabilities as described further below.

18. Consistent with the rationale described in the staff analysis above for the ROU asset, the staff think that Type B leases have a unique, or specialized, role that neither reflects the full transfer of a nonfinancial asset (for example, the purchase of a piece of equipment), nor is equivalent to a service contract. Therefore, Type B leases are not equivalent to a financed purchase of a nonfinancial asset and the lease liability does not need to be explicitly characterized as a debt-like obligation.

19. The main example that many constituents provided during outreach relates to how leases are treated in the event of bankruptcy in some jurisdictions (namely, the U.S.). Under bankruptcy law in these jurisdictions, existing operating leases would be treated differently from existing capital leases, which are more akin to an asset being purchased (either on credit from the supplier or through third-party financing). Existing capital leases will survive bankruptcy as an asset or a lease and result in a claim on the assets of the bankruptcy estate in most scenarios. Conversely, existing operating leases do not result in a claim and will disappear in most bankruptcy scenarios. Accordingly, following this bankruptcy treatment, a lessee would generally characterize Type A leases as debt-like obligations whereas it might be more appropriate to analogize Type B leases to operating-type liabilities (for example, restructuring liabilities or asset retirement obligations). However, the staff note that bankruptcy laws (as well as other factors) differ by jurisdiction. Although characterization of Type B lease liabilities as operating in nature may best depict those liabilities in some jurisdictions, it may not do so in others.

20. The staff also note that for U.S. GAAP, characterization of the lease liability as operating in nature may further support recognition of a single lease expense for Type B leases. This is because, under U.S. GAAP, an entity generally does not present accretion of the discount on operating liabilities as interest expense, but rather as an operating expense. The guidance on the accretion of the discount on restructuring liabilities (Topic 420) is as follows:

> 420-10-35-4 - Changes due to the passage of time shall be recognized as an increase in the carrying amount of the liability and as an expense (for example, accretion expense*). Accretion expense shall not be considered interest cost for purposes of applying Subtopic 835-20.

21. Similarly, the guidance on the accretion of the discount for asset retirement obligations (Topic 410) is as follows:

> 410-20-35-5 - An entity shall measure changes in the liability for an asset retirement obligation due to passage of time by applying an interest method of allocation to the amount of the

> liability at the beginning of the period...That amount shall be recognized as an increase in the carrying amount of the liability and as an expense classified as accretion expense. Paragraph 835-20-15-7 states that accretion expense related to exit costs and asset retirement obligations shall not be considered to be interest cost for purposes of applying Subtopic 835-20.

22. Accretion expense is defined in the U.S. GAAP Master Glossary as follows:

> **Accretion Expense** – "An amount recognized as an expense classified as an operating item in the statement of income resulting from the increase in the carrying amount of the liability..."

23. The staff note that U.S. GAAP guidance with respect to operating liabilties does not provide additional support for a single lease expense under IFRS. IFRS generally requires an entity to present accretion of the discount on any liability (measured on a discounted basis) as interest expense, regardless of whether the liability is debt-like or operating in nature.

24. In addition, the staff note that, based on outreach with some private company lenders in the U.S., the proposed changes to lessee accounting may not impact some debt covenants in the U.S. if the Boards were to characterize Type B lease liabilities as operating liabilities and not debt-like obligations. Based on the outreach performed, smaller companies in the U.S. often have standardized debt covenants that rely principally on one of two ratios: either a leverage ratio or a debt to tangible net worth ratio. The leverage ratio considers all liabilities (both debt-like and operating) because the main focus of the ratio is cash flow. The debt to tangible net worth ratio does not consider all liabilities and focuses on those that are explicitly classified as debt-like. Therefore, companies that have covenants using the debt to tangible net worth ratio may not see a negative impact on that ratio after implementing the leases standard if the Boards decide to characterize lease liabilities as operating in nature, rather than debt-like.

Staff Recommendation

25. The staff recommend that the Boards confirm that:

(a) A lessee should either present on the balance sheet or disclose in the notes both of the following:

(i) Lease liabilities separate from other liabilities.

(ii) Lease liabilities arising from Type A leases separate from those arising from Type B leases.

(b) If a lessee does not present lease liabilities separately on the balance sheet the lessees should disclose which line-items on the balance sheet include lease liabilities.

26. The staff further recommend that the Boards not further specify how a lessee should present lease liabilities on the balance sheet, nor how a lessee should characterize lease liabilities (that is, as debt-like or non-debt like, or operating-type, liabilities). This recommendation does not call into question that lease liabilities are financial in nature (the staff think lease liabilities meet the definition of financial liabilities under both U.S. GAAP and IFRS). However, the staff think that whether a lease liability is, or is not, characterized as debt-like can vary by jurisdiction (for example, in the U.S., current operating lease obligations are not considered debt in the event of bankruptcy, which may suggest characterization of the obligation as operating, rather than debt-like, in nature would be appropriate). Therefore, the staff think the Boards should not attempt to define that characterization in any final leases guidance. The staff think that this would allow lessees the flexibility to present and characterize their lease obligations in the most appropriate manner to their own circumstances, subject to the presentation requirements in the paragraph above.

Question 2
Do the Boards agree with the staff recommendations outlined above with respect to presentation and characterization of lease liabilities?