EFRAG TEG ANALYSIS FOR PUBLIC MEETING

Leases – Presentation of Lease Liabilities

Objective

1 The objective of this paper is to compare the requirements for presentation of lease liabilities under the IASB and FASB decisions, and assess the possible implications.

Background

2 At the December 2014 EFRAG Board meeting, there was a discussion if the presentation of lease liabilities could put European issuers at a disadvantage compared to US issuers (and all issuers complying with US GAAP). Some Board members were concerned that newly recognised operating leases would be treated as part of 'financial debt' under the IASB model and as 'operating debt' under the FASB model. Those members considered that this difference could hurt European issuers by showing higher leverage and making it more likely that covenants based on 'net debt' would be breached.

3 This paper has been discussed at the February TEG meeting so as to provide EFRAG TEG's input to the EFRAG Board.

Presentation of the lease liability.

Where the two Boards agree

4 Both IFRS and US GAAP do not have an explicit definition of 'debt', 'net debt' or a similar metric.

5 Under both IFRS and US GAAP, lease liabilities qualify as financial liabilities.

6 Both IFRS and US GAAP require entities to disclose current and non-current portions of each liability presented.

Where the two Boards have reached different positions

7 In the IASB model, there is only one category of leases for measurement purposes. The IASB has decided that a lessee shall present lease liabilities either as a separate line of the statement of financial position, or include it in another line item. If included in another line item, the entity shall disclose the amount in the notes and indicate in which line item it has been included.

8 Without further guidance regarding presentation, lessees applying IFRS would apply the requirements in IAS 1 *Presentation of Financial Statements*. IAS 1 lists among others 'trade and other payables', 'provisions' and 'financial liabilities' as separate line items to be included on the balance sheets; it also requires to present additional line items, including disaggregating the items mentioned above, when such presentation is relevant to understanding the entity's financial position.

9 Moreover, the IASB is asking to present principal repayments on leases in the financing section of the statement of cash-flows, while interest payments should be presented either in the operating or financing section for non-financial institutions. This is consistent with the general cash flow requirements of IAS 7 *Statement of Cash Flows*.

10 In the FASB model, leases continue to be classified in two types: leases that are in substance purchases of the underlying asset (hereinafter 'Type-A' for simplicity) and other leases (hereinafter 'Type-B'). The distinction is made on the basis of the current principle to distinguish finance leases from operating leases.

11 The FASB has decided that liabilities arising from Type-A and Type-B leases shall be presented separately. Each can be presented as a separate line item on the balance sheet or included in another line item (but not the same line item), with indication in the notes.

12 The FASB decided that the two types should be presented separately because, for example, in the United States, current operating lease obligations are not considered debt in the event of bankruptcy, while capital lease obligations are generally considered in the same manner as other debt.

13 Moreover, the FASB is requiring to present all payments on Type-B leases in the operating section of the statement of cash flows. Principal repayments and interest payments for Type-A shall respectively be presented in the financing and operating section. This is consistent with the cash flow presentation requirements for operating and capital (finance) leases under existing U.S. GAAP and IFRS.

EFRAG TEG input

14 As noted above, neither IFRS nor US GAAP have a definition of 'net debt' and neither Board has explicitly – and officially - indicated what the nature of the lease liability is.

15 However, the FASB requiring separate presentation of the amounts of Type-A and Type-B lease liabilities makes it possible to assess and treat them differently when calculating ratios. This could occur in particular when the amounts are not presented on a standalone basis but subsumed in other line items and aggregated data are used without being adjusted.

16 However, both US GAAP and IFRS preparers still need to separate the short-term and long-term portion of their lease liabilities. If the 'working capital' metric was calculated based on current assets and liabilities, the long-term portion of Type-B lease liabilities would be excluded.

17 Furthermore, the decisions of the Securities and Exchange Commission could also influence practice. Currently, paragraph 5.22 of Regulation S-X requires industrial and commercial entities to present capitalised leases, under the heading long-term debt, together with bonds, mortgages and other long-term debt. If the requirement will stay unchanged after the introduction of the new Standard, this would result in US GAAP preparers presenting a sub-total that includes both amounts and that could be used as a 'net debt' metric.

18 The IASB model being based on all leases having the same economic substance, no distinction would be expected. However IFRS would not preclude entities to break down the total amount of lease liabilities on a voluntary basis subject to two conditions.

19 Firstly, an entity should comply with the requirement in IAS 1 that requires a disaggregation of line items when this presentation is relevant to an understanding of the entity's financial position. Therefore, it is possible that the entity's auditors or regulators would challenge that the disaggregation of the lease liabilities is not relevant.

20 Secondly, an entity would have to apply the classification test with the related additional cost and, therefore, would not benefit from one of the advantages of the IASB approach in terms of cost ; that is that a lessee does not have to apply a classification test to distinguish different types of leases.

21 One main argument used by the FASB to justify a separate presentation of Type-A and Type-B lease liabilities is that their treatment in the US is different in bankruptcy law. Firstly, it is arguable if a presentation based on the treatment in bankruptcy has any conceptual ground. Secondly, even if this criterion was retained, European and other non-US insolvency laws may not make a distinction between different types of leases or the distinction may apply differently than Type-A and Type-B liabilities as defined in the standard.

22 Finally, it should be noted that under the IASB model an entity shall always present a depreciation charge and an interest expense, while under the FASB model an entity presents the whole lease expense for Type-B liabilities in operating expenses. Therefore, the two models will affect differently non-GAAP measures, such as financial risk ratios, and the impact will be sometimes favourable and sometimes unfavourable for IFRS preparers compared to US GAAP preparers.

Use of ‘debt’ in covenants

23 One of the concerns raised by some constituents is that the inclusion of previously unrecognised operating lease liabilities may result in entities breaching their financial covenants. The issue has been raised as potentially significant but at this moment there is no evidence of how common or important it really is.

24 EFRAG Financial Instrument Working Group members have provided the following insights showing that there is a lot of diversity in current practice with the following contributing to reducing the significance of a potential impact:

(a) Currently it is not uncommon that operating leases are already taken into account;

(b) Some covenants are calculated on ‘frozen GAAP’, i.e. the standards in force at the time the agreement is signed;

(c) Certain covenants include revision clauses in case of change in the relevant accounting standards.

Questions to **the EFRAG Board Members**

25 Do EFRAG Board members need further insight into this issues and if so what is it? If so, what activities do they recommend should be performed?