STAFF PAPER

12 October 2011

Capital Markets Advisory Committee Meeting

Paper topic	Using case studies in standard setting

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Purpose

1. This paper asks CMAC members for their views on whether project-specific case studies could be used to:

   (a) increase investor and analyst understanding of accounting proposals and to improve the effectiveness of their input in the standard-setting process; and

   (b) increase the Board's understanding of how investors and analysts use financial statements, and the limitations on the availability of information.

Why using case studies might be helpful in standard setting

2. Investors and other users of financial statements are key stakeholders and participants in the accounting standard setting process. It is important that the Board understands their needs to ensure the development of high quality accounting standards.
3. One strategy for ensuring this happens is to put the Board into the 'shoes of a user' by using case studies that illustrate their information needs and frustrations with the information currently available in financial statements. Approaching accounting issues from a user's perspective could assist in the development and acceptance of workable accounting standards. In addition to providing the Board with an opportunity to experience problems from the users' perspective, case

studies would allow the Board to test the suitability of the end product—that is, the financial statements that companies ultimately will prepare.

Example case study on leases

4. The objective of this particular case study is to determine an entity's capital lease exposure using information that is available in the entity's financial statements. The case study is based on a real world example (information a client was looking for) but the facts have been changed for this discussion.
5. Such an analysis could be useful for the Board in determining which disclosures to require about an entity's lease activities.

Fact pattern

6. Entity A was demerged from Entity B in 20X7. Entity A has three assets that are structured as capital leases. The three lease agreements were entered into at during different times and they were the only capital leases of Entity B, and then of Entity A following the demerger. The financial statements were available on the US SEC website.

Questions to be answered

7. The following information is needed in the analysis:

   (a) When did the assets and liabilities associated with each of these assets come onto the company (and its predecessor's) balance sheet? For each asset, at the date each contract was entered as well as though the life of the contract, what was the:

      (i) PP&E amount for each asset

      (ii) Lease liability

      (iii) Interest rate embedded in the lease contract

      (iv) Service contact component

(v) Pre-payments/deposit

(vi) Capitalized interest

(vii) Depreciation period

(viii) Are cash flows structured to be the same each year or are they variable? How is the cash flow split between interest, liability repayment, and service contract?

(b) A number of events (spin-off, impairments, property damage/ malfunction, accounting errors, etc) occurred since these exposures first started being disclosed in 20X1. What did those effects do to the financial statements and how did they change future earnings, cash flow, and balance sheet patterns of recognition? If these events had not occurred and the contracts had commenced as anticipated at contract entrance, what would pro forma numbers have looked like? Would the analysis be substantially more difficult if rather than a spin-off, it was an M&A transaction?

(c) Income statement: Over the life of these leases, what is the depreciation, interest expense, and executory costs associated with the lease contracts? Are these estimates you arrived at or are they disclosed?

(d) Cash flows: Based on contractual commitments, what are the anticipated cash flow exposures over the lives of these lease contracts?

(e) Cash vs. earnings effects: Based on contract terms at commencement of each lease, what would the anticipated earnings effects and cash flow effects look like over the life of the lease? Given that events identified in (b) above occurred, what do the anticipated earnings effects and cash flow effects look like over the life of the contract? Under both scenarios, what is the annual difference between cash flow effects and income statement effects? Are cash and earnings effects close proxies for each other? If not, would you arrive at different valuation conclusions if you use a valuation approach more focused on earnings or earnings-derived definitions of FCF (non-cash-flow cash flow proxies) than you would using a cash-flow-based DCF based off of actual cash flows?

(f) In what line items are the various earnings effects being recorded in the income statement each year and what are those amounts? Where are the effects recorded in cash flow?

(g) In performing this analysis, where did you have to go to find the information (ie identify the various footnotes you had to use)?

(h) Are these asset and obligation values good proxies for fair values? If not, are fair values disclosed or can they be reasonably estimated? Why might someone be interested in the fair values of the assets and liabilities associated with these assets?

(i) How does the implied discount rate in the lease contracts compare to the company's current cost of debt? What might the lease obligation look like if it were recorded at the company's current cost of debt?

Question
What are your views on the usefulness of using case studies in the standard-setting process?