IFRS FASB

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STAFF PAPER

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Project	**Leases**		
Paper topic	Summary of feedback received during outreach activities		

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Introduction

1. In 2011, the IASB and the FASB redeliberated and reached tentative decisions regarding the proposed lessee accounting model, to be included in a revised *Leases* Exposure Draft. However, in response to continuing concerns raised by constituents about the pattern of lease expense recognition resulting from that lessee accounting model, the Boards discussed a number of alternative ways that a lessee could subsequently measure the right-of-use (ROU) asset at the February 2012 joint Board meeting. At that meeting, the Boards decided that it would be helpful to conduct outreach with preparers and users before making any further decisions on this issue. The primary objective of the outreach was to assess the potential costs and benefits of the different lessee accounting approaches and the usefulness of the resulting accounting information. At meetings with lessors, we also asked about any possible implication for lessor accounting arising from those alternative lessee approaches.

2. This paper is structured as follows:

   (a) Description of the outreach process

   (b) Summary of feedback from users of financial statements

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(c) Summary of feedback from preparers of financial statements

(d) Summary of feedback from auditors of financial statements

(e) Appendix A – Summary of the approaches discussed in the outreach.

Description of the Outreach Process

3. Approximately 100 users, preparers, and auditors of financial statements participated in the outreach undertaken in April and May 2012. Prior to the meetings, the following materials were distributed to participants:

   (a) Background on the four approaches that were to be discussed

   (b) Some examples illustrating the effect on the balance sheet and income statement of each of the four approaches

   (c) A list of questions, tailored by participant type (that is, user, lessee, lessor, or auditor) for participants to consider prior to the meeting.

Users of financial statements

4. Meeting participants, which included 24 users of financial statements, representing individual buy and sell side equity analysts, credit analysts, and representatives of investor groups, gave their views on what information they currently require, what metrics are important to them, and which approach would provide them with the most useful information. The equity analysts also represented analysts of specific industries, for example, retail and airline. The majority of the meetings were conference calls with an individual user/user group representative.

Lessees

5. Meetings also were held with 56 lessees from various countries, who were from diverse industries, including airline, advisory, automobile manufacturing, defence, hospitality, industrial goods, oil and gas, pharmaceuticals, retail, telecom, and

utility. The lessees were mostly from public companies, but there also was representation by nonpublic entities.

6. Sixteen meetings with lessees (and lessors) were held to obtain their views on what the relative costs of applying each of the approaches would be, what practical issues they would encounter in applying each of the approaches, and their thinking on which approach best reflected the economics of their leasing transactions. The meetings were mostly held in person in groups of three to six participants per meeting.

Lessors

7. About 21 lessors from various countries, who were from industries including airline, automobile manufacturing, industrial equipment (health care equipment and utility), and real estate, attended meetings. The lessors were mostly from public companies, but there also was representation by nonpublic entities.

8. Nine meetings with lessors were held (although the lessors were generally included in the meetings held with lessees) in which feedback was given about any implications for lessor accounting arising from each of the approaches. Lessors also gave their views about the practicality of applying the approaches (for example, to identify whether lessors could help lessees obtain the required information relevant to each approach). Those meetings were mostly held in person in groups of three to six participants per meeting.

Auditors

9. Two meetings with eight auditors were held in person, with four participants at each meeting.

10. At each meeting, auditors gave feedback on which approach would result in the greatest cost from an audit perspective, what challenges the participants saw in auditing each of the approaches, and which approach the participants thought was conceptually and/or practically the most appropriate.

Summary of Feedback from Users of financial statements

- Almost all users currently capitalize operating leases. Accordingly, those users view the inclusion of lease assets and liabilities on-balance sheet as a significant improvement to financial reporting
- In making adjustments for operating leases, users currently use a variety of approaches to adjust the balance sheet and income statement.
- No single solution would satisfy all information needs of a majority of users because:
  - Not all users perform the same calculations
  - Users use different pieces of information to analyze the same company.
- Most users would find information about an interest component useful. However, despite wanting the interest component, many users also would like to obtain straight-line total income statement expense information because they use it as a proxy for cash payments.
- Most users supported having a single model for all leases, which is consistent, simple to understand and results in transparent information.

Adjustments users currently make

11. Almost all users that participated in the outreach adjust lessees' balance sheets by recognizing lease liabilities. The method used to measure the liabilities varies. Some users measure the liability using a multiple of annual rent expense. The multiple typically is in the range of six to eight times annual rent expense, but it varies somewhat based on industry and entity-specific factors. Other users measure the liability by discounting the amounts included in the lessees' commitments and contingencies disclosures. The discount rate used typically is the lessees' estimated borrowing rate.

12. Most users that participated in the outreach adjust a lessee's income statement by allocating rent expense (which is typically an operating expense) between

operating and financing expenses. Some users allocate the rent expense using a set rate (for example, 33 percent of rent expense allocated to interest expense and 67 percent of rent expense allocated to depreciation expense), and other users allocate the expense by estimating interest expense corresponding to the liability recognized on the balance sheet, using the lessee's estimated borrowing rate.

13. Users utilize the adjusted information in a variety of ways, including evaluating the following metrics:

    (a) EBIT, EBITDA and EBITDAR[1]: These metrics might be used by analysts to predict future cash flows as one of the inputs to estimating the value of the business as a whole (enterprise value) or the value of the equity. EBITDAR is also sometimes used in the valuation of capital intensive businesses because rent and depreciation are viewed as poor approximations for the ***current*** value of the operating expense. In some cases analysts will back out the depreciation and rent and instead will use replacement value of capital expenditure in determining their cash flow forecast.

    (b) Return on assets (ROA) and return on invested capital (ROIC): These metrics might be used by an analyst to estimate the entity's efficiency at allocating the capital under its control to generate a return for investors. These metrics might be used to compare efficiencies between companies or they might be used to analyze an entity in isolation by comparing the metric to the entity's weighted average cost of capital (WACC) to help determine whether invested capital was used effectively.

    (c) Net debt: This metric is generally calculated by adding short term debt to long term debt and then subtracting cash and cash equivalents. This metric might be used by analysts when trying to gauge the financial flexibility of an entity, either in isolation or when compared to other peer group entities.

[1] The "R" in the acronym is for "rent" (lease expense).

For example, if an analyst wanted to attempt to make two businesses comparable for purposes of equity valuation, they might use EBITDAR because that way they can compare two businesses that have similar business models, but where one business leases its assets through operating leases and another owns its assets.

The analyst would back out depreciation and rent expense and then estimate an economic value for the overall business. The analyst would then estimate the portion of the overall economic value attributable to equity holders by backing out an imputed debt amount for the business with the operating leases, possibly by multiplying the rent expense by an industry multiple.

Views of approaches

14. Almost all users supported the Boards' proposal that a lessee should recognize and measure lease assets and liabilities. A majority of those users were particularly interested in being provided with the lease liability rather than the ROU asset carrying amount.

15. User views were mixed as to whether leases are a form of financing:

    (a) Some users asserted that all leases involve an element of financing (unless all payments are made at lease commencement).

    (b) Some users asserted that there are two types of leases. That is, some leases involve financing and others do not involve financing (or do not involve a significant element of financing). Those users suggesting that leases did not involve financing were mostly involved in the retail industry analysis and they thought that the regular rent payments represented operating costs and were not a form of financing.

16. Although a substantial majority of users supported either Approach A or Approach D (refer to Appendix A), no one solution would satisfy all information needs of a majority of users because (a) not all users perform the same calculations and (b) users use different pieces of information to analyze the same company. For example, a majority of users preferred presenting the interest expense associated with lease payments (which would be consistent with Approach A), but many of

the same users preferred total lease expense to be recognized on a straight-line basis because they often use that information today as a proxy for cash flow information (which would be consistent with Approach D).

17. Some users were attracted to the rationale supporting Approach C and the differing income statement profile, depending on estimated consumption of the underlying asset. However, some of those users also were concerned about the complexity and judgement that would have to be applied under that approach.

18. Most users did not seem to differentiate between Approach B and Approach D because they thought that either approach would provide them with a straight-line expense pattern. Based on their underlying attraction to an approach that will provide them with a straight-line expense pattern, most supported Approach D over Approach B because it appeared to be simpler to understand what the number in the income statement represented.

One or two models for leases

19. A majority of users preferred one lessee accounting model rather than two because they thought one model would facilitate more comparable information across entities, would be simpler to apply, and more transparent. Those users suggested that one model should be applied to all leases and disclosures should be developed to reflect the information that is useful to users but that is not provided by the selected approach. For example, if the Boards were to select only Approach A, some users would recommend requiring disclosure of cash outflows associated with lease payments. Or, if the Boards were to select only Approach D, some users would recommend requiring disclosure of the interest on the lease liability.

20. Some users asserted that they were indifferent as to whether there are one or two approaches to lessee accounting, as long as the information they required was provided.

Concerns

21. The bright lines associated with current leasing guidance were a common concern of users. Users acknowledged that any line the Boards might adopt to distinguish between different lessee models would not result in some leases being on-balance-sheet and others off-balance sheet. Nevertheless, there were concerns about potential income statement structuring and lack of comparability.

22. Some users noted that the measurement of the liability may not always reflect economic reality. For example, some noted that
    (a) lessees can often negotiate to terminate a lease for an amount less than the remaining lease payments.
    (b) lessees need to renew their leases to continue operations so the contractual liabilities may not fully reflect the capital needed to support the business on an ongoing basis.

Summary of Preparer Feedback

Lessee costs of applying the approaches:

- There was no broad consensus among preparers that one of the approaches was, in all circumstances, the least costly. However, a substantial majority thought that Approaches A and D would be much less costly to apply than Approaches B and C.
- All of the proposed approaches would require system changes to capture and account for the lease liability and that would represent the majority of the costs involved in applying the new requirements.

Lessee preferences:

- There was no broad consensus among preparers that one of the approaches was the single best approach that reflected the economics of all lease transactions. Some trends in preferences did emerge based on the nature of lease contracts entered into and the nature of the asset being leased.

Costs of applying the approaches

23. Many lessees that supported Approach D thought it was the most straight forward and practical approach to achieving what they viewed as the Boards' primary objective of recognizing and measuring lease liabilities, while permitting the income statement to reflect the lessees' view of the economics of their leases. Consequently, the lessees thought that Approach D would be the least costly to apply. Some of the reasons provided included the following:

    (a) Less training would need to be provided to their staff to train it in a new approach.

    (b) There would be less cost in providing analysts with the information that they were used to receiving under the current model.

24. Others thought there was no significant difference in the level of complexity or cost between Approaches A and D, mainly because the liability is required to be

measured on a discounted basis under both approaches. The most significant cost associated with the new proposals would relate to:

(a) Initially developing a system and process to capture all the information relating to current operating leases (one-time cost)

(b) Maintaining the inputs to the system and process for subsequent measurement of the liability (ongoing costs).

Some lessees stated that Approach A would be the least costly to apply because the accounting for the ROU asset could be incorporated within their existing fixed asset systems.

25. Most lessees expressed concerns with Approach B that were centered on the perceived complexity of the calculations that are required to derive the amortization profile. Lessees with large portfolios of lease contracts (for example, real estate lessees) stated that many of their lease contracts included regular lease payments and, therefore, the cost of developing a process and system to apply Approach B seemed to be a waste of resources when the same outcome could be achieved when applying Approach D.

26. Some preparers thought that Approach C was practical. However, there were some preparers that thought that applying Approach C would be prohibitively costly. For example, some retail lessees explained that they have over 15,000 real estate leases that are renegotiated on a regular basis, so they thought that the requirement to reassess the consumption pattern would be impracticable. In addition, the lessees that noted concerns with the costs associated with Approach C did not think that the practical expedients would necessarily reduce the cost burden, because, for example:

(a) Some real estate leases were over 10 years (and 10 years was the proposed practical expedient for assuming zero consumption for real estate)

(b) Even if zero consumption could be assumed, the lease payments were not always even meaning the lessees would effectively need to apply

Approach B to those types of leases, which was viewed as overly complex for the outcomes the approach often produced.

27. All lessees noted that Approach C was the most costly, both from a systems perspective and in terms of the judgement that would be required to apply the approach. Therefore, preparers generally had significant cost-benefit concerns about Approach C.

Costs involved in having one or two models for leases

28. Some who favored Approach D preferred applying that approach to all leases because they thought any line arising from having more than one model would increase the complexity of the standard. Others suggested that a line was necessary because they think in-substance purchases should be accounted for as purchases.

29. Some who supported applying Approach A to all leases did so both from a theoretical perspective and because they thought it would be least costly approach. They noted that having one accounting model would avoid the need to assess whether lease contracts fit into one or another model and, therefore, would be the least costly approach in situations in which a lessee has different types of lease contracts.

30. We noted that the support for a single model or multiple models was influenced by the type of leasing contracts that the lessee typically entered into. For example,

    (a) retail lessees often stated that Approach D should be the single model because the vast majority of their leases are currently operating leases.

    (b) oil and gas lessees generally supported Approach A as the single model because they view many of their lease transactions as financing transactions. They also thought that Approach A would be the simplest to apply to the variety of lease contracts that they enter into.

Lessee preferences on the approaches

31. Some lessees think all lease contracts involve financing. Consequently, those preparers generally supported Approach A and measuring the ROU asset on the

same basis as other nonfinancial assets. Nonetheless, some who supported Approach A from an economic or theoretical perspective were concerned about the income statement expense profile, specifically the 'front-loading' effect on net income. However some others noted that, given the volume and composition of their lease contracts, Approach A would not create any significant 'front-loading' effect on net income.

32. Some lessees think that some or all lease contracts do not involve financing. Consequently, they supported Approach D. Many of those lessees think that the benefit received from using the leased asset over the lease term is the same in each period so the total lease expense recognized each period also should be the same.

33. Lessees of real estate (for example, retail and hospitality) almost universally supported Approach D because they do not view real estate leases as financing transactions. Some of those lessees noted that they disagreed with *all* of the approaches because, in their view, such leases do not give rise to an asset or a liability (consistent with their view that those leases do not involve financing). Their preference was to retain the current lease accounting requirements and enhance disclosures. Those preparers asserted that users understand current lease accounting and the costs of implementing new guidance would not outweigh the benefits.

34. Other lessees liked the income statement profile that results from Approach D (that is, no change from current operating lease accounting) but noted that the rationale supporting the recognition of lease assets and liabilities under that approach was weak. They explained that the Boards would need to provide a basis for recognizing and presenting the asset and liability on a gross basis when the lease contract was treated as one unit of account in the income statement.

35. A few lessees preferred Approach B from an economic perspective (in particular, one preparer operating in high-inflationary economies) but most did not think that the benefit of applying the approach would outweigh the additional cost of applying it when compared to Approaches A or D.

36. Some lessees were attracted to the rationale supporting Approach C, noting that it was the best reflection of the economics of their lease transactions. Others questioned the rationale because it focused more on the underlying asset and not on the ROU. The majority of lessees disagreed with Approaches B or C on the basis that the complexity and costs involved outweighed the benefits (if any) outlined in the approaches.

Views on lessor accounting

Symmetry between lessee and lessor accounting

37. There was no universal view among preparers on whether there should be symmetry between the lessor and lessee models. Some mentioned that a lack of symmetry could result in anomalous accounting when accounting for subleases.

Lessor views on practical application of the approaches for lessees

38. Lessors were asked whether they would be able and willing to provide lessees with the information that would be required to apply the approaches, particularly Approach C, which required information regarding the underlying asset.

39. Some lessors stated that they could and would be willing to provide lessees with the information that might help them make judgements (regarding information such as residual lives, fair values, and useful lives). However, some lessors stated that they would not or could not provide lessees with the information that they might need, because of reduced competitive advantage or contractual nondisclosure agreements.

Lessor accounting

40. There was no consensus on whether the receivable and residual approach reflects the economics of leasing from a lessor perspective. Generally, lessors think the receivable and residual model reflects the economics of their leasing transactions when they lease shorter lived assets (for example, equipment and vehicles) and they typically lease those assets only once or perhaps twice before disposing of them. In contrast, lessors do not think the model reflects the economics of their

leasing transactions when they lease longer lived assets multiple times to different lessees, often providing ongoing services to those lessees and actively manage those assets over their economic lives. Those lessors would prefer to retain current operating lease accounting, noting that they believe that their business model is similar to that of a real estate/property lessor (and for which the Boards propose current operating lease accounting).

41. Some thought that the cost of applying the receivable and residual approach outweighed the benefits. They also questioned whether many users think the current lessor model has significant problems and, therefore, that such a change is warranted.

Summary of Auditor Feedback

- Auditors agreed that they could audit all four approaches. However, the costs associated with auditing the approaches would vary. They asserted that Approach C would be the most costly to audit.
- Auditors generally thought Approach A was the most conceptually sound approach, but many recognized that some of their clients think there are different types of lease contracts that should be accounted for differently. Consequently, several of the auditors could support a two-model approach that would apply Approach A to some leases and Approach D to others.
- Auditors generally agreed that if the Boards select Approach D or a two-model approach including Approach D, there is a risk that the project objectives ultimately may not be achieved.

Auditability

42. All auditors agreed that they could audit all four approaches. However, the costs associated with auditing the approaches would vary.

43. Approach C was considered the most costly due to the incremental effort associated with auditing the estimates and judgements needed to apply it that are not needed to apply the other approaches. They asserted that Approach C would be the most costly approach for their clients to implement for the same reasons. Some of those auditors asserted that Approach B may be more costly than Approaches A and D for their clients because the amortization method for the ROU asset is different than all other nonfinancial assets and the calculations necessary to determine the amortization when the lease payments are not even may be complex.

44. In addition, some thought a two-model approach would retain much of the complexity of current U.S. GAAP/IFRSs. Accordingly, they did not think a two-model approach involving Approaches A and D would be a significant enhancement to financial reporting when considering the costs that preparers

would incur to apply the standard and the additional cost that auditors would incur to audit the judgements.

Views on approaches and drawing a line

45. Auditors generally thought Approach A was the most conceptually sound approach, but many recognized that their clients think there are some leases with a financing element and some leases without any significant financing element. Consequently, several of the auditors could support a two-model approach that would apply Approach A to some leases and Approach D to others.

46. In contrast, some auditors expressed support only for applying Approach A to all leases. That is because they did not think there was conceptual merit to Approach D and questioned what meaning the ROU asset would have under that Approach.

47. If a line is drawn for lessee accounting, most of the auditors thought a similar line should be drawn for lessor accounting. They think that having symmetry between the lessee and lessor accounting models would be preferable. However, some noted that symmetry is not necessarily crucial as long as the reasons for differences are clearly explained. Some noted that, if there is no symmetry between lessee and lessor accounting, there is a risk that transactions will be structured so that each party to the transaction will achieve its preferred accounting.

Concerns

48. The auditors generally agreed that if the Boards selected Approach D or a two-model approach including Approach D, there is a risk that the project objectives ultimately might not be achieved for the following reasons:

    (a) Because Approach D treats a lease contract as one unit of account in the income statement on the basis that the asset and liability are inextricably linked during the entire lease term, the auditors think the Boards may

receive significant push-back from some constituents on why the asset and liability could not be presented on a net basis.

(b) Some auditors speculated that some companies would not implement the standard on the grounds of materiality. Entities may be able to apply a relatively high materiality threshold because there would be no difference in the amounts recognized in the income statement under Approach D and current U.S. GAAP/IFRSs, and the asset and liability amounts would be the same or similar. They acknowledged this clearly would not be the case for all entities, but could be for some.

49. Auditors were concerned about impairment testing of the ROU asset under Approaches B and D because the measurement of the asset does not necessarily represent the cost of the asset (at amortized cost) or the fair value of the asset at any particular point in time.

Appendix A – Summary of the Approaches Discussed in the Outreach

Summary of the Approaches

A1. The staff spent time considering the income statement expense pattern for lessees before, during, and after the February 2012 joint Board meeting. Based on the discussions at that Board meeting and the staff's additional analysis, the staff performed outreach on four possible lessee approaches.

A2. The primary changes to the lessee accounting approaches from those discussed at the February 2012 joint Board meeting include (a) the addition of certain practical expedients to Approach C and (b) the addition of Approach D.

A3. The initial recognition and measurement of the liability to make lease payments (lease liability) and ROU assets and the subsequent measurement of the lease liability is consistent among all four approaches and consistent with the Boards' current tentative decisions. The differences among the approaches relate to the subsequent measurement of the ROU asset and, consequently, the lease expense recognition pattern in the income statement. The presentation of lease expense in the income statement is also different under some of the approaches.

Approach A

A4. The ROU asset is accounted for as a nonfinancial asset and is measured at cost less accumulated amortization, similar to any other nonfinancial asset measured at cost (for example, property, plant, and equipment or intangible assets).

A5. The combination of the amortization charge on the ROU asset (which is typically straight line) and the interest expense on the lease liability (which is typically higher in the early years of the lease) results in a total lease expense that would typically decrease over the lease term.

A6. The lessee would present the ROU amortization and the interest on the lease liability separately in its income statement. The amortization charge on the ROU asset is likely to be presented in the same line item as other amortization/depreciation expense while the interest on the lease liability would be presented as a financing expense. That approach is similar to current lessee accounting for finance/capital leases.

Approach B

A7. The interest-based amortization approach views the ROU asset as being different from other nonfinancial assets. Consequently, when subsequently measuring the ROU asset at cost less accumulated amortization, the lessee applies a different amortization method than is typically applied to other nonfinancial assets. That amortization method takes into account the time value of money.

A8. The combination of the amortization charge on the ROU asset (which is typically lower in the early years of the lease) and the interest expense on the lease liability (which is typically higher in the early years of the lease) results in a total lease expense that would often be straight line over the lease term. However, if the pattern of lease payments is faster or slower than the estimated pattern of consumption of benefits from the ROU asset, then the total lease expense in each period might increase or decrease over the lease term.

A9. The lessee would present the ROU amortization and the interest on the lease liability together in its income statement as lease expense, with disclosure of interest on the lease liability in the notes.

A10. This approach produces a result in the income statement that is often similar to current lessee accounting for operating leases.

Approach C

A11. The underlying asset approach views the ROU asset as a combination of two components. The lessee (a) acquires and consumes a piece of the underlying

asset and (b) pays to 'borrow' the residual asset (that is, the piece of the underlying asset that it does not consume) for the lease term. The lessee then returns the residual asset to the lessor at the end of the lease term.

A12. The resulting effect on the income statement varies depending on the terms of the lease. At the extremes:

(a) The lessee consumes all of the underlying asset and there is no residual asset when the lease term is for the entire economic life of the asset. In that case, this approach produces a result in the income statement that is similar to current lessee accounting for finance/capital leases.

(b) The lessee consumes none of the underlying asset and the residual asset does not decline in value over the lease term. In that case, this approach produces a result in the income statement that is similar to current lessee accounting for operating leases (when lease payments are relatively even over the lease term).

A13. The lessee would present the ROU amortization and the interest on the lease liability separately in its income statement. The amortization charge on the ROU asset is likely to be presented in the same line item as other amortization/depreciation expense while the interest on the lease liability would be presented as a financing expense.

Approach D

A14. The whole contract approach considers the ROU asset and the lease liability that arise from a lease contract to be one unit of account when initially and subsequently measuring those balances. This approach views the ROU asset as being different from other nonfinancial assets and different from the underlying asset itself. That is because the ROU asset is inextricably linked to the lease liability, not only at lease commencement, but also throughout the lease term. This approach also does not view a lease contract as a financing transaction.

A15. The lessee would allocate the total lease payments evenly over the lease term resulting in straight-line total lease expense. That would be the case even if the pattern of lease payments is not equal throughout the lease term.

A16. The lessee would present the total payments as lease expense.

A17. This approach produces a result in the income statement that is the same as current lessee accounting for operating leases.