STAFF PAPER

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Project	**Leases**		
Paper topic	Analysis of effects of proposals for lease accounting		

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Purpose of this paper

1. We would like to get CMAC members' views on some aspects of the staff's draft analysis of the effects of the lessee accounting proposals, which the IASB plans to publish with its revised *Leases* Exposure Draft (ED) in Q1 2013. The final analysis of the effects of the leases proposals will also include a section relating to lessors that is not addressed in this paper.

2. The paper includes some extracts from an initial draft of the effects analysis of the proposals for lessees, which is being prepared by the staff and has not been reviewed or approved by the IASB. That draft of the effects analysis is a work-in-progress, and will continue to change over the coming months as our thinking regarding the structure and content of effects analyses evolves.

What is an effects analysis?

3. The IFRS Foundation Trustees are proposing that effects analyses should be a formal due process requirement for all projects. The effects analysis section in the proposed IASB's Due Process Handbook says the following (adapted in the context of the leases project):

> In evaluating the likely effects of the proposals in the Revised Exposure Draft for leases, the IASB has considered the following factors:

(a) how the changes are likely to affect how activities are reported in the financial statements of those applying IFRSs;

(b) how those changes improve the comparability of financial information between different reporting periods for an individual lessee and between different entities in a particular reporting period;

(c) how the changes will improve the quality of the financial information and its usefulness in assessing the future cash flows of a lessee;

(d) the benefit of better economic decision-making as a result of improved financial reporting;

(e) the likely effect on compliance costs for lessees, both on initial application and on an ongoing basis; and

(f) how the likely costs of analysis for users (including the costs of extracting data, identifying how the data has been measured and adjusting data for the purposes of including them in, for example, a valuation model) are affected. The IASB should take into account the costs incurred by users of financial statements when information is not available and the comparative advantage that preparers have in developing information when compared with the costs that users would incur in developing surrogate information.

Summary of leases proposals

4. The IASB and FASB are proposing that a lessee should recognise lease assets and liabilities for all leases, except those shorter than 12 months. Lease assets and liabilities are initially measured at the present value of the minimum lease payments, and subsequently measured on an amortised cost basis. Although a lessee will recognise lease assets and liabilities, the pattern of recognition and presentation of lease-related expenses will depend on the extent to which a lessee consumes the economic benefits of the asset that it is leasing over the lease term:

(a) For most *equipment and vehicle leases* for which the lessee typically consumes a substantial portion of the equipment or vehicle's economic benefits, a lessee would amortise the lease asset on a typically straight-line basis, within operating expenses or a similar caption. The lessee would also recognise interest on the lease liability, within financing costs.

(b) For most *property leases* (ie leases of land and/or a building) for which the lessee consumes very little (if any) of the property's economic benefits, a lessee would recognise a single lease expense on a straight-line basis, within operating expenses. Interest on the lease liability would be disclosed in the notes, as part of a reconciliation of beginning to ending balances of the lease liability.

5. In terms of disclosures, a lessee would be required to provide (among others):

(a) reconciliation of beginning to ending balances for lease liabilities and lease assets;

(b) narrative descriptions about the terms of leases and any significant judgements and assumptions made; and

(c) a maturity analysis of undiscounted future minimum lease payments.

6. In the remainder of this document, we refer to each type of lease as an equipment lease or a property lease. This is not a strictly accurate portrayal of the lease proposals. Although the IASB expects a substantial proportion of equipment and vehicle leases to be classified as 'equipment leases' and a substantial proportion of property leases to be classified as 'property leases' (as we use those terms in this document), there will be some property leases accounted for similarly to finance leases in IAS 17, and there will be some equipment leases for which the lessee will recognise a single lease expense on a straight-line basis (eg a three year lease of a rail car with a 50-year life).

Draft effects analysis of the leases proposals for lessees

7. The effects analysis compares the proposals for lease accounting that will be included in the forthcoming revised *Leases* ED to the existing lease accounting requirements in IAS 17 *Leases*.

8. The following paragraphs include some extracts from an initial draft of the effects analysis (relating only to the effect on lessees). The extracts summarise the effects of

the lessee accounting proposals for each of the factors listed in the proposed Due Process Handbook and set out in paragraph 3 above.

9. The proposals will not materially change the accounting for leases currently classified as finance leases. Accordingly, any effects noted in the following paragraphs arise from changes to the accounting for leases currently classified as operating leases.

How the changes are likely to affect how activities are reported in the financial statements of those applying IFRSs

10. This section of the analysis will discuss the effect of the proposals on the financial statements of lessees, including the additional disclosures required to be made by lessees.

11. The following is an extract from the draft analysis on the effects of the proposals on a lessee's financial statements:

> Effect on the statement of financial position
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> i) For an operating lease accounted for in accordance with IAS 17, a lessee recognises lease expense arising from the minimum lease payments during the lease term typically on a straight-line basis. The lessee recognises any other expenses as they are incurred. The lessee does not recognise any lease-related assets and liabilities except for accruals and payments due.
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> ii) In contrast, the Leases ED proposes that at commencement of a lease, a lessee would recognise a lease liability and an asset representing the right to use the leased asset, unless the lease is a short-term lease. This change would significantly affect the size of the statement of financial position for many entities. This effect would be different for individual entities, depending on factors such as the capital intensity of the business, lease versus buy policies, proportion of leases accounted for as operating leases in IAS 17, average lease terms and regulatory environment.
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> iii) In the proposals, the newly recognised lease asset would be classified as a non-current non-financial asset, and the lease liability would be classified as a current or non-current financial liability, depending on when payments are due.
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> iv) For equipment leases, a lessee would subsequently measure the lease asset differently from the lease liability—the carrying amount of the right-of-use asset would typically reduce more quickly than the carrying amount of the lease liability. This in turn would result in a reduction in reported shareholders' equity compared

to operating lease accounting in IAS 17. The level of the reduction would depend on the length of the lessee's leases, the discount rate applied and the average period remaining until the end of the lease term.

v) For property leases, the IASB expects little effect on reported shareholders' equity.

Effect on profit or loss

vi) The presentation in profit or loss of lease-related expenses arising from an equipment lease would be different from that for operating leases in IAS 17. The proposals would require a lessee to recognise interest expense on the lease liability, presented as part of finance costs, and amortisation of the lease asset, presented as part of operating expenses or a similar line item within which lease expenses for operating leases would have been presented.

vii) Furthermore, the total amount recognised for the lease related expense would be different in any individual reporting period, for an individual lease. According to the proposals in the Leases ED, the sum of the interest expense and amortisation during the first half of the lease term would be higher than the straight-line operating lease expense recognised in accordance with IAS 17. Consequently, there would be a negative effect on profit or loss for leases that are in the first half of the lease term. The effect would be the opposite, ie positive, for leases in the second half of the lease term because, at that point, the sum of interest and amortisation would be lower than the straight-line operating lease expense recognised in IAS 17. Over the lease term, the total amount of expense recognised would be the same.

viii) Lessees typically hold a portfolio of leases at any one time, and the size of effect on profit or loss would depend on the structure of the portfolio and terms of the individual leases within it.

ix) For example, if a lessee's lease portfolio is equally distributed (ie same number of leases commence/expire during a period) and the lessee enters into new leases with similar terms and conditions to those that expire, then the overall effect on profit or loss would be neutral for such a portfolio. If the composition of the portfolio changes significantly, either because of a change in the number of leases or because new leases have different terms from the leases that expire, then there would be an effect on profit or loss. However, the change in the portfolio would have to be significant to have a noticeable effect on profit or loss.

12. This section will also include a summary of expected changes to key ratios used in assessing the financial performance and financial position of a lessee, such as:

Ratio	What it measures	How it is calculated	Leases applicable to	Expected effect	Explanation
Gearing	long-term solvency	liabilities /equity	All	increase	increase as reported debt increases (and equity reduces)
Current ratio	liquidity	current assets /current liabilities	All	decrease	decrease as current lease liabilities will be reported (ie current liabilities increase) and no new current assets will be reported
Asset turnover	profitability	sales/total asset	All	decrease	decrease as lease assets will be added
EBIT	profitability	profit before interest and tax	Equipment	increase	increase as the amortisation added is lower than the rent expense eliminated
EBITDA	profitability	profit before interest, tax, depr and amort	Equipment	increase	increase as there will be no rent expense
EBITDAR	profitability	profit before interest, tax, depr, amort and rent exp	All	no change	no change because it excludes all lease-related expenses
Operating profit	profitability	n/a	Equipment	increase	increase because the amortisation added is lower than the rent expense eliminated, ie interest would be reported below operating profit line
Net income	profitability	n/a	Equipment	depends	depends on characteristics of lease portfolio and tax rate
EPS	shareholder	net income /number of shares in issue	Equipment	depends	depends on the effect on net income, which depends on characteristics of lease portfolio and tax rate
ROCE	profitability	EBIT/total assets less current liabilities	Equipment	depends	depends on whether existing EBIT is lower than the ratio of ROU asset amortisation/non-current lease liability and on the proportion of the total financing structure that relates to lease liabilities
ROCE	profitability	EBIT/total assets less current liabilities	Property	decrease	EBIT will be the same but total assets less current liabilities will be higher therefore reducing the reported ratio
Net cash flow	profitability	n/a	all	no change	no change because the proposals do not affect cash
Operating cash flow	profitability	n/a	Equipment	increase	increase because at least part of lease payment (relating to principal) will be moved to the financing section

How those changes improve the comparability of financial information

13. This section will discuss how the proposals will improve comparability.

> i) One of the biggest criticisms of IAS 17 is the bright line between finance and operating leases, with very different accounting on either side. This means that two very similar transactions from an economic perspective could be reported very differently, which reduces comparability between entities (an example that is sometimes cited is that of a 20-year lease of an aircraft, which is accounted for as an operating or a finance lease, depending on how the lessee applies the application guidance).
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> ii) Even though the IASB proposes to retain two types of lease, it believes that the proposals will significantly improve comparability for the following reasons:
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> (a) A lessee would recognise assets and liabilities for both types of lease, unlike IAS 17, in which assets and liabilities are recognised for one lease type but not for the other. This reduces the difference in the accounting that results from classifying a lease as one type versus the other.
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> (b) Initial and subsequent measurement of the lease liability for both types of lease is identical, and similar to the measurement of similar financial liabilities. Users of financial statements often place more emphasis on the lease liability in their analyses.
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> (c) Initial measurement of the lease asset is identical and subsequent measurement is similar. Even though subsequent measurement is different for an individual lease, some of these differences will cancel each other out at a portfolio level.
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> (d) The line between the two types of lease is different from the line drawn in IAS 17, better reflecting differences in the economics of different types of leases.

14. The section will also compare the proposals for leases to the accounting for purchases, a comparison that is often made when analysing leasing.

> Applying the Leases ED, accounting for leases and purchases will be more comparable because a lessee would recognise assets and liabilities arising from leases. Nonetheless, entities that buy assets and entities that lease them would not report the same amounts in the statement of financial position and profit or loss. The IASB thinks that this is appropriate because, even though some are economically similar, leases and purchases are not the same transactions. A lessee controls the right to use the leased asset, not the leased asset itself, and only has an obligation to make payments

specified in the lease. However, recognising assets and liabilities arising from purchases as well as leases aids comparability. In addition, when a lease is economically similar to purchasing the leased asset, the amounts recognised by the lessee should be very similar under the proposals.

How the changes will improve the quality of the financial information and its usefulness in assessing the future cash flows of a lessee

15. This section will discuss the relevance and predictive value of information about lease liabilities, and why disclosure is not a good-quality substitute for recognition.

> Providing information about lease assets and liabilities will make financial reporting more relevant than when applying IAS 17. Information about lease liabilities has predictive value, because it provides information about minimum future cash outflows in relation to leases, which is useful for decision-making.
>
> Some argue that the disclosure of lease commitments, similar to that required by IAS 17, already provides quality financial information and is helpful in assessing future cash flows. Although the disclosures provided for operating leases in line with IAS 17 also have predictive value, that information is not as useful on its own because it is shown only on an undiscounted basis. This also makes it less comparable and incomplete compared with information provided for other financial liabilities that are recognised and measured on a present-value basis.

16. The section will discuss why the IASB concluded that recognition is needed, despite the fact that most users of financial statements currently make adjustments to capitalise operating leases.

> An argument that is sometimes used to support the view that there is no need to recognise lease assets and liabilities is that many users of financial statements already make adjustments to the financial statements to include lease assets and liabilities on a present value basis, and use adjusted financial statements for their decision-making. The information provided by IAS 17, however, is not sufficient for users to make these adjustments. Consequently, they use estimates and shortcuts (eg to determine discount rate and allocate future minimum lease payments between individual periods) when making adjustments to financial statements. The result is that different users arrive at different conclusions, all of which may be very different from the lessee's actual financial position.

17. The section will also discuss the effect of the decisions on term options and variable lease payments on the quality of financial information (the ED proposes that

payments to be made in optional periods and variable lease payments relating to future performance or usage are generally excluded from the measurement of a lessee's lease assets and liabilities). Based on feedback received in response to the previous ED, the draft document notes that the IASB concluded that including those lease payments when measuring lease assets and liabilities would not improve the quality of information sufficiently to outweigh the costs for (a) preparers to provide the information, and (b) users of financial statements to decipher the quality of the information. Users who responded to the 2010 *Leases* ED, and those we have spoken to more recently, have mixed views on including payments in optional periods and variable lease payments in the measurement of lease assets and liabilities.

> Some IASB members were concerned that, even though including the variable lease payments in the measurement of the lease assets and liabilities from commencement of the lease might provide more complete information, it would not result in faithful representation of the lease because of the potential bias and uncertainty involved in their measurement, and therefore not result in relevant information for users. The IASB has therefore decided to not require the measurement of all options and variable lease payments, but to require narrative disclosures about the terms of those payments that are not included in the measurement.

The benefit of better economic decision-making as a result of improved financial reporting

18. This section will discuss the variety of adjustments currently made by users of financial statements with respect to operating leases and how the availability of better information about leases should improve decision-making.

> i) In the outreach that the IASB conducted with investors and analysts during the first half of 2012 (including buy and sell side equity analysts, credit analysts and representatives of investor groups), almost all participants said that they adjust the statements of financial position of lessees by calculating lease liabilities for operating leases. The method they use to measure the liabilities varies. Some of them measure the liability using a multiple of annual rent expense. The multiple is in the range of six to eight times annual rent expense, but it varies somewhat based on industry and entity-specific factors. Other measure the liability by discounting the amounts included in the lessees' commitments and contingencies disclosures. The discount rate used is typically the lessees' estimated borrowing rate.

ii) Investors and analysts use the adjusted information in a variety of ways, including evaluating the following ratios:

(a) EBIT, EBITDA and EBITDAR: these measurements might be used by an analyst to predict future cash flows as one of the inputs for estimating the value of the business as a whole (enterprise value) or the value of equity. EBITDAR is also sometimes used in the valuation of capital-intensive businesses that have significant rentals as a part of their operations (eg airlines or restaurants), because rent and depreciation are viewed as poor approximations for the current value of the operating expense. In some cases, an analyst will “back out” the depreciation and rent and instead will use the replacement value of capital expenditure in determining their cash flow forecast.

(b) ROA and ROCE: these measurements might be used by an analyst to estimate an entity’s efficiency at allocating the capital under its control to generate a return for investors. These measurements might be used to compare efficiencies between entities or they might be used to analyse an entity in isolation by comparing the measurement to the entity’s weighted average cost of capital (WACC) to help determine whether invested capital was used effectively.

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

iii) The IASB’s proposals for leases would improve the quality of information used by investors and analysts, which are expected to reduce the need to make assumptions and estimates when assessing a lessee’s debt and, ultimately, lead to better decision-making.

19. The section will also discuss the perceived negative consequences including increased cost of borrowing, behavioural changes and structuring as well as some regulatory concerns. It will explain the IASB’s view that the aim of the proposals is to reflect economic reality and provide more transparency about a lessee’s leverage.

A major concern for some is the effect that they think the leases requirements will have on the cost of borrowing for lessees. The IASB’s outreach with users of financial statements confirmed that many of them (including all the credit rating agencies that took part) already take into account operating leases when determining a lessee’s debt.

Capitalising leases on the statement of financial position should therefore not have such an effect on the cost of borrowing. It is not the case that leases would only start to be considered as a result of the proposed requirements. Rather, leases would be considered on the basis of more accurate information. Consequently, the cost of borrowing for some lessees may go up or down, depending on how different their actual lease liabilities are from those that had been estimated by users. Because users of financial statements often use industry-wide estimates, the effect for individual lessees could be significant, depending on how different the lessee's position is from the assumptions that had been made by the users of its financial statements. Such changes, if they occur, would therefore be a result of improved transparency, resulting in better decision-making and, ultimately, better capital allocation.

Effect on compliance costs for preparers

20. This section will describe the costs for preparers to implement the proposals, and acknowledge that for some preparers those costs may be significant. It also will mention how simplifications in recognition and measurement compared to the 2010 *Leases* ED should significantly reduce the costs they would have likely incurred under those proposals.

i) The IASB expects that the introduction of these leases requirements will result in significant costs for lessees with leases that are classified as operating leases in IAS 17, particularly on initial application.

ii) Even though lessees of operating leases need to disclose a schedule of future minimum lease payments, which is the same information needed to measure the lease liability, it is the IASB's understanding that most entities do not use sophisticated systems to prepare this information. It is therefore likely that lessees, especially those with a significant number of leases that span over several reporting periods, will need to invest in new systems to be able to report in accordance with the proposed requirements. Additional cost will arise from the need to determine the discount rate and apply judgements where needed.

iii) There will also be incremental costs on ongoing basis to reassess the lease liability and remeasure it as needed. However, for many leases there will be no lease remeasurements during the lease term, such as leases without options and without variable lease payments linked to an index or a rate. Also, even when a lease contains options, reassessment is not likely to be onerous as the threshold for recognition is quite high. Therefore, changes in the assessment of the lease term are expected to be relatively rare.

iv)	The proposals in the previous *Leases* ED published in 2010 were more onerous, requiring recognition of the longest lease term more likely than not to occur and measurement of all variable lease payments using probability-weighted estimates. The IASB also proposed that these requirements would be subject to regular reassessments. The IASB organised a number of workshops to test the practicality of these proposals and the feedback received was that they were too complex and costly. The IASB considered this and other feedback received and decided to simplify the requirements.
v)	In summary, in arriving at its decisions, the IASB has considered those costs and believes that the information produced as a result of those decisions would outweigh the costs of providing it. In revising the proposals, the IASB has removed a lot of complexity and additional cost that would have been imposed if the 2010 *Leases* ED had remained unchanged. This includes the removal of the requirement to measure variable lease payments and options using probability-weighted estimates.

Effect on costs of analysis for users of financial statements

21. This section will summarise the expected costs for users of financial statements in relation to using the financial information that would be provided in accordance with the proposals.

> The IASB does not expect any increase in the cost of analysis for the users of lessee financial statements. Some users would have reduced costs because they will no longer make adjustments based on their own estimates and will instead use reported information. Others will continue making adjustments to suit their needs, but those adjustments are expected to be less costly than the adjustments made to capitalise operating leases because more information would be available.

Questions for CMAC members

22. Are there any key effects, which are either not mentioned or mentioned only briefly, that you think should be discussed (more fully) in the effects analysis?

23. Do you think the effects analysis would be helpful in informing users of financial statements about the proposed changes to financial reporting?

    (a) Do you have any suggestions for improving the way in which the effects can be communicated to users of financial statements?