Advisory Council 25 February 2014 – Agenda Ref 4

International Financial Reporting Standards

The Leases project

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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It's time for decisions

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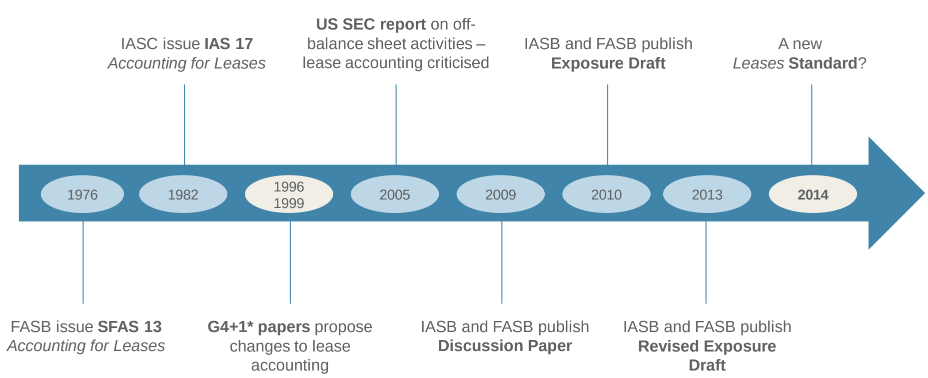
- 18 years since first proposal to report operating leases on the balance sheet



* The G4+1 was a working group consisting of board members and senior staff members of accounting standard-setters from Australia, Canada, New Zealand, the UK, the US, and the (IASC) that was established to undertake a study on leasing.

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The need for change

- Under existing accounting standards, operating leases are not reported on a lessee's balance sheet
- Off-balance-sheet lease financing numbers are substantial

	Percentage of IFRS/US GAAP preparers who report material operating leases	
Listed companies only	Africa / Middle East	27%
	Asia / Pacific	52%
	Europe	47%
	Latin America and Caribbean	14%
	United States and Canada	54%
	Total future minimum operating lease payments (undiscounted) (1)	**USD 4.3 trillion**
	Present value of future minimum operating lease payments (estimate) (2)	**USD 3.4 trillion**
	Global annual equipment leasing volume (new leases only), 2012	**USD 0.9 trillion**
	Global real estate volume unknown, but substantially more than equipment	

(1) As per the companies 2012 annual reports.
(2) Estimate using the average cost of debt for these companies, that was 5%.

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Investors adjust the balance sheet…

- Many investors and analysts currently adjust a lessee's balance sheet to understand the leverage arising from operating leases
- The most common technique used by analysts seems to be a multiple of the annual rent expense, the multiple often being 7 or 8
- In most cases this results in liabilities that are substantially inaccurate

	Analysts estimated liabilities of IFRS/US GAAP preparers	
Listed companies only	Using a multiple of 8 times operating lease expense (1)	**USD 5.1 trillion**
	Present value of future minimum operating lease payments (estimate) (2)	**USD 3.4 trillion**

(1) As per the companies 2012 annual reports.
(2) Estimate using the average cost of debt for these companies, that was 5%.

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...Some also adjust the income statement

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- Lease expense can be seen as including (at least) two elements: depreciation and interest
- Under existing IFRS, a lessee reports operating leases within operating expenses, and does not report interest expense
- Without adjustment, this may impact the valuation of a company
- Consequently some investors and analysts currently adjust a lessee's income statement for operating leases
- The most common technique used is to split the operating lease expense into depreciation and interest using simplistic techniques (for example, two-thirds depreciation and one-third interest)

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Moving forward

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- Feedback on the 2013 ED
  - Most, included preparers, agree leases create assets and liabilities
  - Majority of investors and analysts*, most regulators and many standard-setters support recognition on the balance sheet
  - Concerns about cost and complexity
  - Many preparers oppose recognition on the balance sheet
- 3 possible approaches for lessee accounting were discussed at the January 2014 joint board meeting – decisions expected in March 2014

Strong opposition expected regardless of which approach adopted primarily because of the significance of the change to many lessees' balance sheets

* See attached recommendation to the IASB from the CMAC (the IASB's investors advisory group)
* See attached summary of investors and analysts feedback on the 2013 ED

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Enhancing disclosure is not enough

- All 3 approaches for lessee accounting discussed in January 2014 would require a lessee to recognise assets and liabilities for leases of more than 12 months.
- IASB thinks that disclosure in the notes is not a substitute for reporting assets and liabilities arising from a lease.
- Failing to report those assets and liabilities on the balance sheet provides a misleading picture of the financial position of a lessee.
- European Accounting Association-led review of recent academic literature on leases was very helpful and identified several empirical studies supporting lease capitalisation.
- Based on feedback received, boards might not propose any significant change to existing lessor accounting.

3 approaches for expense recognition

- The 3 approaches differ mainly in terms of the recognition and presentation of lease expenses in the income statement
- The following table shows the **expenses recognised** for each approach, compared to existing IFRS (IAS 17 *Leases*)

IAS 17	Lessee approach 1	Lessee approach 2		Lessee approach 3 = IAS 17*
	Single model	**Dual model**		**Dual model**
Finance leases Operating expenses Financing expenses	Operating expenses Financing expenses	Operating expenses Financing expenses		Operating expenses Financing expenses
Operating leases Operating expenses	Operating expenses Financing expenses	*Non-real estate* Operating expenses Financing expenses	*Real estate* Operating expenses	Operating expenses

*Approach 3 is identical to IAS 17 with respect to the income statement recognition.

3 approaches for expense recognition

- The following table compares the 3 proposed approaches

	Lessee approach 1	Lessee approach 2	Lessee approach 3
	Single model	**Dual model**	**Dual model**
Cost and complexity	Least complex because single model does not require lease classification.	More complex than Approach 1 because of lease classification.	More complex than Approach 1 because of lease classification.
Conceptual basis	Right of use model.	Right of use model, but classification linked to the underlying asset. Some have conceptual concerns.	Right of use model, but classification based on risks and rewards transfer. Some have conceptual concerns.
Supported by	Many investors and analysts; most accounting firms/advisors; some regulators; many standard-setters; some preparers.	Some investors and analysts; some regulators; some standard-setters; some preparers (especially real estate lessees).	A few investors and analysts; a few standard-setters; a few accounting firms; many preparers (particularly US).
Feedback from investors and analysts	Provides useful information about liquidity / leverage / capital commitments. Supported by most credit analysts and some equity analysts.	Provides useful information about liquidity / leverage / capital commitments. Supported by most industry-specific analysts (eg retail analysts, transport analysts).	Provides useful information about liquidity / leverage / capital commitments. Supported by a few analysts.

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Risk of non convergence

- It's too early to determine the outcome of deliberations, but…
  - January joint discussions indicate the IASB and the FASB agree that operating leases should be reported on a lessee's balance sheet
  - The critical question for the boards is whether a lessee should report depreciation of the asset separately from interest on the lease liability, or instead report a single lease expense within operating expenses
- There is a possibility that the IASB and the FASB might reach different conclusions regarding how a lessee reports lease expenses in its income statement

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Reduce cost and complexity

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- A priority for the IASB is to reduce cost and complexity—possibilities under consideration include:
  - Exclude leases of 'low value' assets
  - Apply leases guidance at a portfolio level
  - Extend the one year 'short-term lease' exemption
  - Simplify the remeasurement of lease assets and liabilities
  - Simplify lease classification
  - Simplify separation of lease and non-lease components
  - Simplify disclosure and transition requirements

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What advice do you have?

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- The IASB has consulted extensively
  - extensive outreach meetings
  - comment letters
  - roundtables
  - fieldwork meetings with preparers
  - meetings with investors and analysts
- The IASB is obliged to evaluate and balance all feedback

The Advisory Council's views are an important part of the overall feedback the IASB will evaluate when moving forward to finalise a new leases standard

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