

AGENDA PAPER

IFRS Foundation Trustees meeting – Due Process Oversight Committee

MILAN 28 JANUARY 2014

Agenda ref 3F

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Reporting of Outreach and Fieldwork and Correspondence: update

Introduction

1. The purposes of this paper are to provide updates on (a) the IASB's on-going efforts to improve the transparency reporting of feedback from outreach and fieldwork, and (b) whether any correspondence has been received on due process issues since the DPOC's meeting held on 16 October 2013 in Frankfurt.

Reporting of Outreach and Fieldwork

Outreach

2. In our October report to the DPOC (Agenda Paper, AP, 3G for that meeting refers) we indicated ways in which the staff are endeavouring to improve the reporting of feedback from investors and users of financial statements, particularly with respect to those who wish to remain anonymous. This included conducting additional surveys of users, and perhaps using more structured interviews/questions during their outreach meetings.
3. For this meeting, we are responding to the Committee's request to be kept updated on the staff's efforts. The staff understand the importance of gathering this feedback in a transparent yet confidential way, and are continually considering better ways to achieve their objectives. In the light of this, a suggestion has been made that, when meeting with investors, the staff could capture the main points from these meetings and ask the investor, or external meeting chair if it is a group of investors, to confirm that the staff have accurately documented the discussions.
4. This would improve the staff's documenting of these meetings whilst maintaining confidentiality and would not unduly increase the staff's work load. These meeting notes would remain confidential and would be used to prepare a summary of the feedback received from investors/users for publication on the IASB's public website. These summaries would be similar to the comment letter summaries that the staff currently prepare in order for the Board to discuss the feedback received on the various proposals.

5. The Leases team has already prepared a similar summary of their user outreach activities. This was originally in response to requests for information about the feedback we have received from investors and analysts about the lessee accounting proposals. The summary details the feedback that the IASB and the FASB received at meetings with investors and analysts on the lessee accounting proposals, without attributing feedback to individual investors. The summary has been posted to the leases page on the public IASB website¹, and is reproduced as Appendix A to this report. (Note that the feedback in the summary is for meetings that took place from May to September 2013. Further investor and analyst meetings were arranged in September and October 2013 to discuss both the lessee and lessor accounting proposals. We will also receive input from investors and analysts in comment letters. A more complete analysis of all of the feedback received from investors and analysts will be included in future board papers and the website will be updated to include this outreach.) The staff have referenced this summary several times in subsequent meetings with stakeholders and have received a positive response to their efforts at improving the transparency of these discussions.
6. We believe that using this type of summary will increase the level of transparency of our investor/user outreach whilst maintaining the level of confidentiality that these stakeholders desire. To further supplement the information within these summaries we will be asking the teams to include a breakdown of the feedback received by region and type of investor (ie buy-side, sell-side, equity, fixed income).
7. The Insurance team has already started gathering this additional information for their feedback document. A paper summarising the feedback from the IASB's outreach with users of financial statements is being presented to the Board at its January meeting. A copy of the paper is attached as AP 3F(i). In addition to the overall comments on the accounting for insurance contracts and comments related to topics that the IASB specifically was seeking feedback on, the Insurance paper includes the number of meetings with investors, number of investors spoken to, the number of comment letters received and an analysis of discussions with investors by type of respondent and by region.
8. We believe that the creating this type of summary for each project will go a long way to address the DPOC's request to improve the reporting of feedback from investors and users of financial statements, particularly with respect to those who wish to remain anonymous. In addition, as Yael Almog noted in her October 2013 Executive Director's report to the Trustees (AP1A for that meeting refers), we have hired Alison Thomas, formerly of PwC, to consult with us on our investor outreach strategy. Alison has been working with Barbara Davidson, Principal - Investor Liaison, on this strategy for the past two months. As part of this work Alison and Barbara are looking at additional ways of

¹ The summary can be accessed at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/Lessee-accounting-investor-outreach-summary-May-to-September-2013.pdf>.

obtaining feedback from investors /users as well as working to encourage investors/users to send public comment letters to the IASB. This work should further enhance the transparency of the feedback received from these groups. We will provide a report on the results of this work later in 2014.

Fieldwork

9. At its October 2013 meeting, the DPOC also noted that the IASB's Effects Analysis Consultative Group (EACG) was tackling the issue of transparency, in particular in relation to fieldwork (AP 3D for that meeting refers). It was noted the reporting of fieldwork raised similar issues with regard to confidentiality, as many participants are prepared to participate only under conditions that their names or the detailed work performed would not be made public.
10. At that meeting, it was noted that, during 2013, the IASB undertook work with a group of banks and corporates to assess the likely effects of the proposed expected credit loss model on loan loss provisions. The fieldwork involved participants applying the impairment approach proposed in the IASB's Exposure Draft (ED) *Financial Instruments: Expected Credit Losses* to a number of selected portfolios using a hypothetical scenario provided by the IASB. Some of the participating organisations had spent over 500 hours on this work, with one devoting over 600 hours, but all on a confidential basis, not least given the hypothetical nature of the fieldwork and the fact that the detailed calculations and assessments could include price-sensitive information. Without the assurance of confidentiality, the IASB would not have been able to conduct this fieldwork.
11. At the meeting, we plan to discuss with the DPOC – in the context of the impairment exercise – a number of issues, notably the selection of fieldwork participants; how the fieldwork was conducted, including the interaction with participants; and how the results of the fieldwork were analysed and presented to the IASB. On this last point, the main results and observations arising from the fieldwork were reported in publicly available papers to the IASB at its meetings in July 2013² and September 2013³. As noted in previous DPOC meetings, the staff's objective remains to report as transparently as possible while respecting confidentiality. But the confidentiality of the fieldwork does raise issues both of transparency and of how much validity can be placed in the results. Having said that, the IASB believes that the impairment fieldwork exercise did have a number of benefits, in that:
 - a. it allowed the field participants to actively engage with the IASB to better understand the proposals and to provide us with enriched and valuable feedback

² Agenda Paper (AP) 5B, available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/July/05B-Impairment.pdf>.

³ AP 5E, available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/September/05E-Impairment.pdf>.

based on their experience, as they had to consider in detail how they will implement our proposals (and alternative models); and

- b. by working with field participants the staff have obtained a more thorough understanding of the mechanics of measuring expected credit losses (both 12 month and lifetime), techniques to adjust forward-looking information, potential approaches to assess credit deterioration and the effects and relevance of discounting.

Correspondence

12. At the time of writing (15 January), no new correspondence requiring the DPOC's attention has been received.

Appendix A**Leases—Summary of outreach meetings with investors and analysts on proposed accounting by lessees May – September 2013****Introduction**

1. This summary outlines the feedback that the IASB and the FASB (the boards) received at meetings with investors and analysts on the lessee accounting proposals included in the *Leases* Exposure Draft published by the boards on 16 May 2013. Those outreach meetings were held between May and September 2013.
2. This summary does not include all of the feedback that we expect to receive on the lease accounting proposals from investors and analysts. Further investor and analyst meetings have been arranged in September and October 2013 to discuss both the lessee and lessor accounting proposals. We will also receive input from investors and analysts in comment letters. A more complete analysis of all of the feedback received from investors and analysts will be included in future board papers.
3. We have also had, and will continue to have, meetings with preparers and others to discuss the costs associated with the lease accounting proposals. A full summary of all feedback will be included in future board papers.
4. We have prepared this summary in response to requests for information about the feedback we have received from investors and analysts about the lessee accounting proposals.

Background

5. The lessee accounting proposals aim to address the criticisms of existing lease accounting by proposing that a lessee would recognise assets and liabilities for all leases of more than 12 months. To reflect the differing economics of different leases, the Exposure Draft also proposed that most real estate leases would be reported differently from most other leases (eg equipment and vehicle leases) in a lessee's income statement and cash flow statement.
6. The boards asked investors and analysts three main questions about the proposals:
 - (a) Do leases create assets and liabilities for a lessee and, if so, should they be recognised on a lessee's balance sheet?
 - (b) What are your views on the proposed changes to a lessee's income statement?
 - (c) What are your views on the proposed note disclosure package?
7. The materials prepared for discussion included an explanation of how lease assets and lease liabilities would be measured under the proposals—ie to reflect the contractual commitments of the lessee, discounted at the rate in the contract or the lessee's incremental borrowing rate. The materials also included an illustration of how the proposals would be expected to affect the

financial statements of a retailer and an airline, two of the industry sectors that would be most affected by the proposals.

Population of investors and analysts consulted during outreach

8. From May to September 2013, the boards and staff have received feedback on the lessee accounting proposals from more than 220 investors and analysts who attended more than 35 meetings. Around half of those meetings were in-person meetings, most of which were at the investor's or analyst's offices; while the other meetings were telephone calls. Meetings held with the boards' respective user advisory groups (the FASB's Investor Advisory Committee and the IASB's Capital Markets Advisory Committee) were held in public. Other meetings were held in private. Meetings generally included at least one Board member and staff.

9. The investors and analysts who participated in the outreach are employed by various organisations. The investors and analysts represented their own views and not necessarily the views of their employers. The majority of those who participated are equity analysts, but we also consulted credit analysts including analysts from the credit rating agencies. Those who participated included both sell-side and buy-side analysts—many focus on particular industry sectors that engage in significant leasing activities (eg airlines, shipping companies, transport companies, retailers, restaurateurs, hoteliers, industrial companies), while others cover the markets more generally and a few are accounting analysts. Those who use the financial statements of nonpublic entities in the United States also participated in the outreach.

10. The investors and analysts we spoke to are located in Europe (Belgium, France, the Netherlands, Switzerland, Sweden and the United Kingdom), the United States, Canada, Hong Kong, Japan, Australia, New Zealand and South Africa.

Operating lease adjustments made by investors and analysts

11. Investors and analysts are interested in obtaining information about a lessee's leasing activities, in general, to assess the cash flows, returns and capital structure of the lessee, and to assess the lessee's ability to meet financial commitments.

12. The majority of the investors and analysts consulted already make adjustments to a lessee's reported balance sheet to capitalise operating leases when operating leases are significant to the lessee. Two main techniques are used to adjust the balance sheet—(a) multiple of annual operating lease expense and (b) discounted operating lease commitments.

13. The majority of those who adjust for operating leases estimate the lease asset and the lease liability 'missing' from a lessee's balance sheet by multiplying the annual operating lease expense by a multiple—the most common multiple used is 8, but ranges from 5 to 12. Relatively few estimate the lease asset and the lease liability by using the operating lease commitments note disclosures. Those who use that technique make some assumptions about the timing of cash outflows, estimate an appropriate discount rate and calculate the lease asset and lease liability by discounting the expected future cash outflows. A few investors and analysts use both techniques and either pick the highest number as the estimated lease asset and lease liability or calculate a blended number, combining the outcomes from both techniques.

14. Some investors and analysts do not currently make adjustments for operating leases. Some noted that this is because they do not consider operating leases to be significant to the companies in which they invest. In a few parts of the world, however, adjustments are not typically made even for industry sectors that have significant operating leases (eg retail and shipping).

15. Regarding the income statement, many also adjust a lessee's income statement for operating leases. The most common technique used is to split the operating lease expense for the period into depreciation (two-thirds) and interest expense (one-third). Some use a similar technique but use a 55:45 split between depreciation and interest expense. Those who estimate the balance sheet adjustments by discounting operating lease commitments, typically estimate the operating lease interest expense using the discount rate applied to measure the balance sheet amounts. The difference between the total operating lease expense and the estimated interest expense is then treated as depreciation.

16. Others do not directly adjust the amounts reported in a lessee's income statement but use metrics such as EBITDAR (earnings before interest, tax, depreciation, amortisation and rent) in their ratio analyses. This means that all expenses associated with owned and leased assets are added back to the earnings metric used. This technique is used more frequently by those focusing on industry sectors within which individual companies have substantially different proportions of owned and leased assets (eg airlines, food retailers) with the intention of improving comparability.

17. The credit rating agencies adjust a lessee's balance sheet, income statement and cash flow statement for operating leases. Other than the credit rating agencies, relatively few of the other analysts we spoke to adjust a lessee's cash flow statement for operating leases.

Views on the lessee accounting proposals

Balance sheet (recognition and measurement proposals)

18. Credit analysts consulted generally support the changes proposed to a lessee's balance sheet. Their main focus is assessing the credit risk of a company and, thus, they are particularly interested in getting better information about leverage. They are of the view that all leases create assets and liabilities for a lessee and should be recognised on a lessee's balance sheet. They consider lease liabilities, including operating lease liabilities, to be debt-like obligations or 'interest-bearing debt'. Accordingly, almost all of those consulted think that reporting lease assets and liabilities, measured on a consistent basis to reflect a lessee's contractual commitments, would be a significant improvement to financial reporting. The views of those credit analysts reflect that almost all noted that the information available in note disclosures about operating leases today is insufficient for their analyses—eg they noted that there is a huge variation in the quality and quantity of information provided by lessees.

19. Analysts consulted within the credit rating agencies also generally support recognising lease assets and lease liabilities on the balance sheet. Similarly to the views of the other credit analysts, they think that leases create assets and debt-like liabilities for a lessee. Thus, they are of the view that requiring a lessee to recognise contractual commitments arising from operating leases on the balance sheet, measured on a consistent basis, would provide useful information.

20. In addition, financial statement users (lenders) of nonpublic entities in the United States generally support recognising lease assets and lease liabilities on the balance sheet.

21. The views of equity analysts are more mixed. Many of those consulted agree that operating leases create assets and liabilities for a lessee and adjust for them accordingly. Most equity analysts agree that information about a company's leverage is important for their analyses—ie they need to assess credit risk as well as operating performance when analysing a company—and they agreed that the proposals will provide better information about leverage. Some also noted that they think that large parts of the wider investor community do not adjust for operating leases. Consequently, they think that those investors are severely underestimating leverage for some companies when screening potential investments or making investment decisions.

22. Nonetheless, some equity analysts noted concerns as follows.

(a) Some are concerned about any change to financial reporting. Change potentially disrupts trend information and may force them to re-examine the models they use for analyses. Some said that financial information is only a small part of the information they assess when making investment decisions and they are comfortable with the adjustments they already make for operating leases.

(b) Many equity analysts' primary focus is to assess the operating performance of a company. For industries within which some companies own most of their assets and others lease most (eg airlines, other transport companies), analysts are interested in obtaining 'whole asset' information about leased assets (ie information about how much would be capitalised if the company had purchased, rather than leased, the assets). This is to ensure they have a comparable asset base (or capital employed) on which to assess the companies' respective performance. The balance sheet proposals do not provide that information when lease terms are for periods considerably shorter than the economic life of the asset (eg a 7-year lease of an aircraft with an economic life of 25 years). Because of this, equity analysts that cover, for example, the aviation sector have indicated that they are likely to continue to adjust reported information to get to a 'whole asset' number for leased assets when assessing operating performance. Analysts within one of the credit rating agencies have also indicated that they expect to continue to make such adjustments. In contrast, those who follow other transport companies leasing trucks and vans have informed us that they expect to use the information that would be provided under the proposals, without further adjustment. One of those transport analysts noted that the operating lease adjustments currently made can overstate the assets and liabilities of transport companies. This is because applying a multiple of 7 or 8 to the annual operating lease expense results in adding lease assets and liabilities that are significantly higher than the assets and liabilities that would exist if the company purchased the trucks and vans and financed those purchases.

(c) Other equity analysts focus primarily on a lessee's lease commitments when making adjustments for operating leases. Some are interested in obtaining information about a lessee's contractual commitments and, thus, indicated that the information provided under the proposals would be beneficial for their analyses. For example, one retail analyst noted that it is particularly important to understand a retailer's contractual lease commitments (and thus its flexibility) due to the increase in internet shopping within particular retail sectors. Others, however, noted that they

are trying to get to a measure of the on-going ‘perpetual’ commitments of a company, ie the level of commitment or ‘debt’ needed to continue operating on a similar basis to today. They think that limiting the measurement of the lease asset and lease liability only to contractual commitments is not helpful. Consequently, some of those would suggest only improving disclosures and not changing a lessee’s balance sheet and income statement.

(d) Some retail equity analysts who do not already adjust for operating leases question whether real estate leases should be reported on a retailer’s balance sheet. They noted that the particular retailers that they follow tend to have shorter-term leases, which they view as commitments that are not equivalent to debt-like obligations. They think that retailers can often get out of or renegotiate their operating lease commitments, which makes those commitments different from other forms of debt and similar to other commitments not recognised on the balance sheet. Others, however, noted that operating lease commitments can act exactly like other forms of debt when a company is in distress and, for example, its leased retail locations are underperforming. Consequently, those analysts think it is important to have more accurate information about operating lease commitments and view the recognition of lease assets and lease liabilities as an improvement to financial reporting.

Measurement of lease assets and liabilities

23. Investors and analysts consulted generally support the proposed measurement of variable lease payments and options, ie excluding variable lease payments linked to sales or use and, in most cases, excluding optional renewal periods. Almost all noted that they would not want subjective estimates about variable lease payments and renewal options included in the reported asset and liability amounts. In their view, it would make the balance sheet amounts less reliable and, thus, less useful for their analyses. A number of investors and analysts also think that it is more appropriate to reflect the economic difference between fixed and variable lease payments, and non-cancellable and optional lease periods, on a lessee’s balance sheet as proposed—a lessee with contracts with variable lease payments and optional renewal periods has a lot more flexibility than those making fixed payments in non-cancellable periods.

24. However, some investors and analysts, including those within one credit rating agency, had the opposite view. They would prefer management to include an estimate of expected payments in the future, including expected variable lease payments and optional payments. In their view, this would give them better information about expected future cash outflows. Some of those analysts, however, noted concerns about the reliability of those estimated amounts. Despite a preference for recognition on the balance sheet, the credit rating agency analysts noted that sufficient disclosures in the notes about renewal options and variable lease payments would be likely to serve their information needs in this respect.

Income statement proposals

25. Most, but not all, investors and analysts consulted agree that there are economic differences between most leases of real estate and leases of equipment and vehicles. They, therefore, understand the rationale behind the dual approach proposed for a lessee’s income statement.

26. Many of the industry-specific investors and analysts support the proposals for the income statement. Almost all airline and transport analysts consulted agreed with the proposal to

recognise and present amortisation and interest expense separately for equipment and vehicle leases because, in their view, there should be consistency in the treatment of owned and leased assets. They also view the lease liability to be a debt-like obligation and, thus, they think it is appropriate to have interest relating to the lease liability recognised as interest expense in the income statement.

27. Retail, restaurant and hotel analysts generally support having a single lease expense for real estate leases, typically presented as an operating expense—they view the lease expense as an important part of the operating expenses of a retailer/hotelier/restaurateur. Some of those analysts would view the lease liability as operating debt, as opposed to interest-bearing debt, and thus support the income statement proposals. Nonetheless, the majority of those retail/restaurant/hotel analysts consulted view the lease liability to be a debt-like obligation and some currently adjust a lessee's income statement to split the operating lease expense into depreciation and interest expense. Some of those retail, restaurant and hotel analysts noted that they were comfortable with the income statement proposals for real estate leases even though they would treat the lease liability as a debt-like obligation because they would continue to use an EBITDAR metric when analysing companies. This means that, for those analysts, it does not matter whether amortisation and interest expense is recognised separately in the income statement (as proposed for equipment leases), or a single lease expense is recognised (as proposed for most real estate leases), because those analysts would add back all such expenses to net profit when analysing companies.

28. In addition, some investors and analysts who support a distinction between most real estate leases and equipment leases would consider the entire lease expense for most real estate leases to be a financing expense because the entire amount paid represents a financing cost for the lessee for use of the real estate.

29. Others disagree with having two different approaches in the income statement, expressing support for all leases to be treated in the same way in the balance sheet and income statement. Most of those who disagree with the income statement proposals propose recognising amortisation and interest separately for all leases (ie applying the accounting proposed for equipment leases to all leases). This reflects their view that leases create assets and debt-like liabilities—for real estate leases, those investors and analysts think there is tension between the balance sheet and income statement proposals. This is because there would be no corresponding increase in operating profit and interest in the lessee's income statement to mirror the change in the balance sheet to add debt-like liabilities.

30. In contrast, some investors and analysts who disagree with the income statement proposals would suggest that a single, straight-line lease expense should be recognised for all leases currently classified as operating leases. This reflects their view that for these leases the benefit to the lessee is received evenly over the lease term. Although most of those investors and analysts agree that leases create assets and liabilities, they generally prefer to only improve disclosures (see further comments under 'Disclosures' below).

31. Most of those who support the balance sheet proposals, and yet disagree with the dual approach in the income statement, support the project overall. They are willing to accept the

proposals in the income statement to achieve what they consider to be an improvement to financial reporting.

Cash flow statement proposals

32. Not all investors and analysts consulted expressed views on the cash flow statement proposals. Of those who did, there are two main views:

(a) Analysts within some of the credit rating agencies and some others support the cash flow statement proposals for equipment leases (ie treating cash payments as the repayment of debt). This reflects the adjustments they already make for operating leases. They also make adjustments at present to treat a new lease as part of the capital expenditure of a company (ie they treat a new lease as an investing cash outflow (capital expenditure) and a financing cash inflow (obtaining debt financing)).

(b) Other investors and analysts would prefer to treat all lease cash outflows as part of operating activities. Even though many of those users view lease liabilities to be debt-like liabilities, they view the actual cash flows to be payments for assets that are used in the operations of the lessee. They are concerned that only the interest element of lease payments would be presented within operating and investing cash outflows (the 'principal' portion would be presented as cash outflows from financing activities). Consequently, there would be an increase in free cash flows that, in their view, is not appropriate because there is no change to the actual cash flows.

Disclosures

33. Not all investors and analysts consulted expressed views on the disclosure proposals. Of those who did, there was general support for those proposals. A few themes emerged:

(a) Many investors and analysts would like to see a single disclosure of the total lease expense and a breakdown of the components of that expense.

(b) Some requested disclosure of the average discount rate used to measure lease liabilities.

(c) Some requested additional disclosures about remaining lease terms by class of underlying asset.

(d) Many noted the importance of having interest on the lease liability disclosed in the notes if that information is not available on the face of the income statement.

(e) Some suggested that lease assets and lease liabilities should be presented as separate line items on the balance sheet if significant.

34. Some investors and analysts have suggested not changing the recognition and measurement of leases, but only improving note disclosures. They do not think that any one amount can provide a complete picture of the economics of leases. Among other disclosures, they would suggest that a lessee should be required to disclose a range of possible future cash outflows relating to leases, taking into account management's expectations for renewal options and variable lease payments.