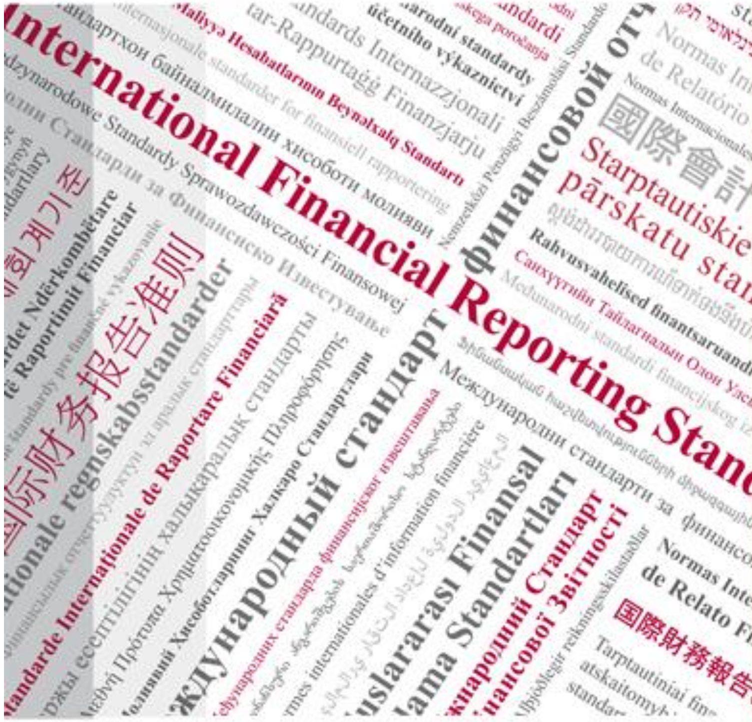
International Financial Reporting Standards



GPF meeting, March 2014
Agenda paper 4A

The Leases project

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

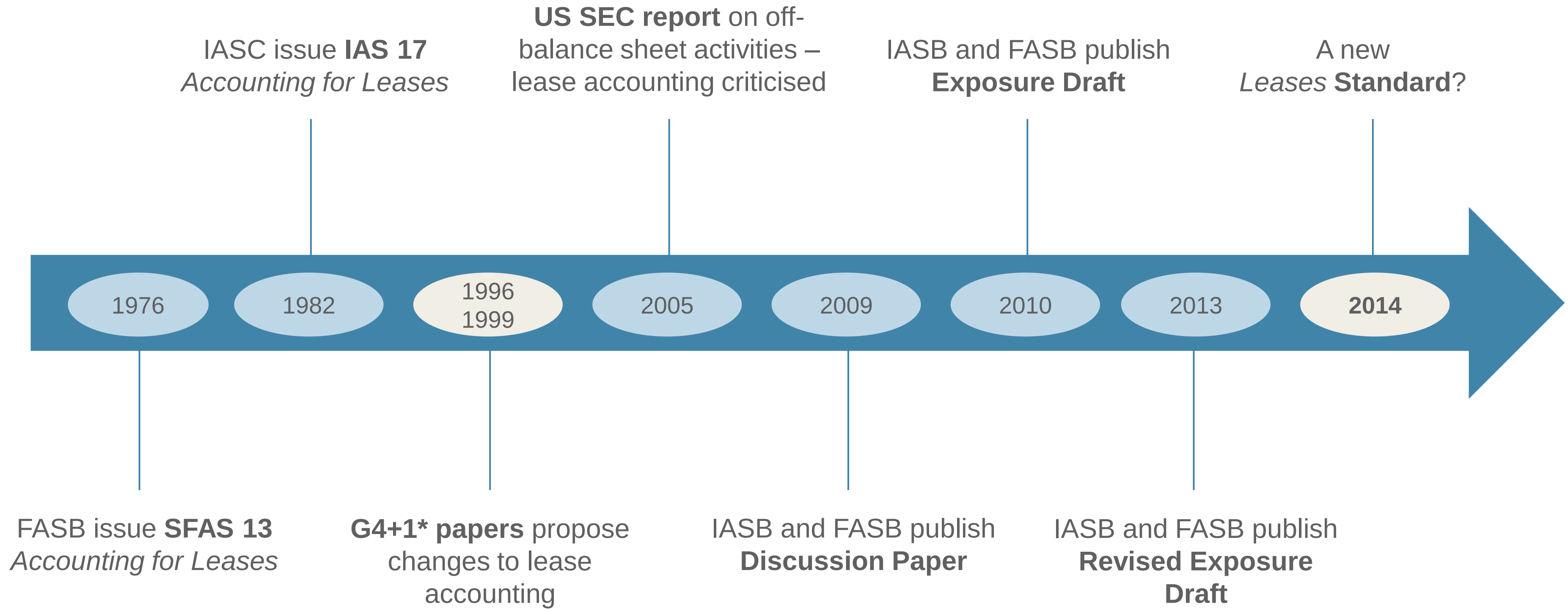
Agenda

- High-level background
- Going forward
  - To discuss possible simplifications in slides 9-16
  - To discuss other approaches/simplifications

High-level background

It’s time for decisions

- 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.

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

Listed companies only	**Percentage of IFRS/US GAAP preparers who report material operating leases**	
	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%.

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

Listed companies only	Analysts estimated liabilities of IFRS/US GAAP preparers	
	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%.

…Some also adjust the income statement

- 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)

Going forward

Moving forward

- Feedback on the 2013 ED
  - Most, included preparers, agree leases create assets and liabilities
  - Majority of investors and analysts, most regulators, many standard-setters (including some preparers) 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

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.

Reduce cost and complexity

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

Small ticket leases—low value assets

- Exclude from the recognition requirements leases of assets that have both of the following characteristics:
  - The value of the asset is individually small
  - The asset is a non-specialised assets that would be used, without modification, by entities across industry sectors
- Examples could be used to illustrate that such leases generally would include leases of some classes of IT and office equipment, such as laptops, desktops, water dispensers, mobile phones, office furniture. Leases of cars, trucks and real estate would *not* represent leases of low value assets.

Small ticket leases—noncore assets

- Exclude from the recognition requirements leases of noncore assets.
- Core and noncore = revenue generating versus administrative
- Could this be made operational?

Small ticket leases—short-term and portfolio

- Extend the exemption for short-term leases in two possible ways:
  - To increase the short-term threshold beyond 12 months; or
  - To change the definition of a short-term lease to be consistent with the proposed definition of lease term.

- Clarify that a lessee can apply the leases guidance at a portfolio level.

Simplify lease classification

- All 3 lessee accounting approaches discussed at the January 2014 joint board meeting simplify lease classification compared to the 2013 ED:
  - Approach 1—no lease classification
  - Approach 2—no lease classification for non-real estate leases; IAS 17 lease classification for real estate leases
  - Approach 3—IAS 17 lease classification for all leases

- Refer to slides 7 and 8 for further information about the lessee accounting approaches

Simplify measurement: reassessment of the lease term

- Remove the reassessment requirements; or
- Require reassessment only upon the occurrence of one or more ‘triggering events’ that would indicate a significant change in relevant factors relating to the exercise of renewal or termination options

Simplify measurement: reassessment of VLPs

- Subsequent measurement of variable lease payments (VLPs) that depend on an index or a rate
- Remove the reassessment requirements; or
- Require reassessment only when there is evidence that remeasuring the liability would lead to a significant change in that measurement

Simplify separation of lease and non-lease components

- Permit a lessee to estimate the payments relating to lease and non-lease components in the absence of observable standalone prices (similar to the requirements in paragraphs 14 and 15 of IFRIC 4)
- Permit, by class of underlying asset, a lessee to account for lease and non-lease components together as a single lease component rather than separating the components, possibly only in some circumstances (eg if the lessee determines that the service component is small)