STAFF PAPER

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IASB Meeting – Education session

Project	**Leases**
Paper topic	Cover memo

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Objective of the meeting

1. The purpose of this meeting is for the IASB to discuss the leases agenda papers 3-3H in advance of the joint board meeting to be held on 18 and 19 March 2014. This is an educational meeting only.

2. In addition, we attach some background information on the effects of the proposed changes to lessee accounting. Throughout the project, we continue to gather information that helps to assess those effects. The attached document provides the IASB with an update of more recent analysis performed.

Leases project
The effects of the proposed changes to lessee accounting
March 2014

Introduction

1. This paper summarises some of the more recent work that we have done in assessing the effects of the proposed changes to lessee accounting.
2. Throughout the leases project, we have continued to assess the effects of the proposed changes to lease accounting on the financial statements of lessees. The 2013 Exposure Draft *Leases* included the IASB's work in assessing the effects of the proposed changes in May 2013. More recently, we have used financial data aggregators to quantify the estimated effect of the proposed changes to the financial statements of lessees.[1]
3. The IASB and the FASB are proposing that a lessee would recognise assets and liabilities for all leases, other than short-term leases. In accordance with the existing lease requirements, a lessee recognises assets and liabilities only for leases classified as finance leases. A lessee does not recognise assets and liabilities for leases classified as operating leases. Accordingly, when assessing the effects of the proposed changes to lessee accounting, we have analysed information available about leases classified as operating leases in accordance with existing lease requirements.

[1] Financial data aggregators refer to databases that compile financial information available in the financial statements of listed entities. It should be noted that the data used may contain errors – the information included in this paper should, therefore, be used with a degree of caution. We are in the process of verifying the data, which is not yet complete.

The effect of recognising assets and liabilities on a lessee's balance sheet

4. The following table provides a summary indicating the prevalence of the use of operating leases by listed entities across the world:

Percentage of IFRS/US GAAP preparers who report material operating leases *(listed entities 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)***	**USD 4.3 trillion**

5. Further analysis of lease liabilities for entities listed in Europe, North America and Asia / Pacific reveal that about 1,000 of these entities account for over 80 per cent of total lease liabilities on these three regions, according to their latest annual reports (even though over 12,000 listed entities report material operating leases).
6. We have used a sample of these 1,000 entities as a starting point for further analysis. These entities each have estimated operating lease liabilities of at least USD 300 million, calculated on a discounted basis. However, we have excluded banks from the sample because of the disproportionate size of their respective balance sheets as compared to other entities, resulting in a sample of 950 entities.

7. The sample is summarised as follows:

Region	Number of entities	Proportion of total lease liabilities for the region
Europe	**243**	**80%**
North America	**454**	**74%**
Asia / Pacific	**253**	**75%**

8. The summary of the effect of the proposed changes to the balance sheets of lessees, by region, is shown in the following table. The table compares (a) the lease liability, estimated by discounting the minimum future lease payments at the average cost of borrowing in the region (excluding banks), and (b) the lease liability, estimated by multiplying the operating lease expense by 8 (a technique commonly used by investors and analysts).

	Europe		North America		Asia / Pacific	
USD million	Present value basis	Multiple of 8	Present value basis	Multiple of 8	Present value basis	Multiple of 8
Long Term (LT) debt	1,923,239	1,923,239	2,693,749	2,693,749	1,006,318	1,006,318
Imputed operating lease liability	*377,743*	*646,554*	*618,109*	*921,258*	*461,253*	*482,395*
Adjusted LT debt	**2,300,982**	**2,569,793**	**3,311,858**	**3,615,007**	**1,467,571**	**1,488,713**
LT debt to total assets	13%	13%	17%	17%	17%	17%
Adjusted LT debt to total assets	**16%**	**18%**	**21%**	**23%**	**25%**	**26%**
LT debt to equity	64%	64%	57%	57%	44%	44%
Adjusted LT debt to equity	**77%**	**86%**	**70%**	**77%**	**64%**	**65%**

9. On the basis of this information, we have the following observations:

(a) As expected, the effect on reported leverage (that is, the debt to equity ratio) is significant at around 15 per cent, on average.

(b) The estimation techniques used commonly by investors and analysts often over-estimate a lessee's lease liability. Within the figures summarised above, there are individual entities with long-term leases for which the estimation techniques under-estimate their lease liabilities, and others with shorter-term leases for which the estimation techniques over-estimate their lease liabilities.

(c) The estimated lease liability for Asia / Pacific entities under both techniques is similar. One possible explanation for this is that the leases entered into in the Asia / Pacific region may be for longer terms than in other regions.

10. In addition to our own analysis, we also obtained information from a constituent that analysed the size of the operating lease commitments of 500 listed entities in the FT Europe 500 index.[2] The analysis compares the undiscounted operating lease commitments to the total assets of these 500 entities listed in Europe on the basis of their most recent financial statements.

11. Some extracts of the findings are as follows:

(a) For all 500 companies, the total undiscounted operating lease commitments represented only 1.2% of total assets. Accordingly, if all 500 entities were consolidated into one entity, the effect of the proposed changes to lessee accounting would not be very significant.

(b) The industry analysis indicates that the prevalence of operating leases is dramatically different for different industries, ranging from 0.2% for insurance entities and banks to 39% for general retailers. The undiscounted operating lease commitments are more significant for entities in sectors, such as retail, transportation, telecommunications and support services. Nonetheless, other than travel and leisure (which includes some airlines and some hoteliers) and retail, the total undiscounted operating lease commitments for each sector are less than 10% of the total assets for those entities. Again, assuming that all entities within each industry sector were consolidated into one entity, it would appear that relatively few industry sectors would be significantly affected by the proposed changes to lessee accounting.

(c) However, the information provided for each entity indicates that there can be very significant differences in the use of operating leases within an industry sector. For example:

(i) Within the industrial transportation sector, undiscounted operating lease commitments as a percentage of total assets

[2] The appendix to this paper includes a summary of the leasing information obtained for these 500 entities listed in Europe.

represents 9.9% for the entire sector, more than 20% for 3 of the 12 entities in that sector, between 5% and 20% for 5 of the 12 entities and less than 1% for 4 of the entities within that sector.

(ii) Within the media sector, undiscounted operating lease commitments as a percentage of total assets represents 7% for the entire sector, 85% for one of the 20 entities in that sector, between 10% and 20% for 4 of the 20 entities and less than 10% for the remainder.

(iii) Within the support services sector, the percentages range from 43% to 0% for individual entities.

(iv) Within the fixed line telecommunications sector, two entities of a similar size in terms of their total reported assets have respective undiscounted operating lease commitments of 11% and 0.8% of total assets.

12. This analysis shows that operating lease commitments can be very significant across some industries and for some individual entities. It also shows the range in significance of operating leases across industry sectors and, more importantly, within industry sectors. This supports the view that additional transparency around lease liabilities would provide useful information.

13. Even when adjustments are being made today, they are often likely to be inaccurate. For many lessees, the adjustments currently being made overstate assets and liabilities but, for others, those adjustments understate assets and liabilities, as indicated by the table in paragraph 8.

The effect of recognising interest on the lease liability as a financing expense on a lessee's income statement

14. In the 2013 Exposure Draft, the IASB and the FASB proposed, for some existing operating leases, that a lessee would recognise interest on the lease liability separately from amortisation of the asset recognised from a lease (ie the right-of-use asset).[3] A lessee would present interest on the lease liability as a financing expense, and the amortisation of the right-of-use asset within the same line item as similar expenses such as depreciation of items of property, plant and equipment. This accounting was described as Type A accounting in the 2013 Exposure Draft.

15. The main difference in a lessee's income statement between Type A accounting and existing operating lease accounting is likely to relate to the recognition and presentation of interest on the lease liability as a financing expense.[4] For existing operating leases, a lessee recognises the entire operating lease expense as an operating expense. According to Type A accounting, a lessee would recognise and present the interest embedded within the existing operating lease expense as a financing expense. Accordingly, a lessee's profit before interest and tax would increase under Type A accounting compared to existing operating lease accounting.

16. To test this effect of applying Type A accounting, we used the same sample of 950 entities described earlier in this paper in paragraph 6.

17. The summary of the effect of applying Type A accounting on a lessee's income statement, by region, is shown in the following table. The table shows the estimated effect on lessees' profit before interest and tax of applying Type A accounting. The table compares (a) the imputed operating lease interest expense, estimated by multiplying the average borrowing cost in the region (excluding banks) by the

[3] The IASB and the FASB also proposed that, for some existing operating leases, a lessee would recognise a single lease expense in its income statement, which was referred to as Type B accounting in the 2013 Exposure Draft. Type B accounting would not be expected to result in any material difference in a lessee's income statement compared to existing operating lease accounting. Consequently, this document does not further assess the effects of applying Type B accounting on a lessee's income statement.

[4] For an individual lease, the amount of total lease expense recognised in any single period would differ between Type A accounting and existing operating lease accounting. However, when a lessee has a portfolio of leases that start and end in different periods, any difference in that total lease expense recognised would be expected to be largely mitigated. Accordingly, the main difference in a lessee's income statement between Type A accounting and existing operating lease accounting would be expected to relate to the presentation of interest component.

imputed operating lease liability, and (b) the imputed operating lease interest expense, estimated by dividing the total operating lease expense by 3 (a common technique used by investors and analysts to adjust a lessee's income statement).

	Europe		North America		Asia / Pacific	
USD million	Present value basis	1/3 rent = interest	Present value basis	1/3 rent = interest	Present value basis	1/3 rent = interest
Sales	6,221,588	6,221,588	8,840,514	8,840,514	4,293,176	4,293,176
Profit before interest and tax	539,146	539,146	1,096,897	1,096,897	318,778	318,778
Imputed operating lease interest expense	*19,075*	*26,940*	27,464	38,386	22,336	22,604
Adjusted profit before interest and tax (Type A)	**558,221**	**566,086**	**1,124,361**	**1,135,283**	**341,114**	**341,382**
Increase in profit margin % before interest and tax	**0.3%**	**0.4%**	**0.3%**	**0.4%**	**0.5%**	**0.5%**

Increase in profit margin % before interest and tax by number of entities

Range	Europe	North America	Asia / Pacific
< 1%	**68%**	**68%**	**55%**
1 – 5%	**28%**	**29%**	**33%**
5% - 10%	**3%**	**2%**	**8%**
> 10%	**1%**	**1%**	**4%**

18. On the basis of this information, we have the following observations:

(a) The aggregated effect on a lessee's profit margin before interest and tax of between 0.3% and 0.5% is not very significant. Accordingly, if all of these entities were consolidated into one entity for reporting purposes, we would conclude that there is little difference in a lessee's income statement between Type A and existing operating lease accounting.

(b) For many individual entities, the difference is also not very significant. The analysis indicates that an individual lessee's profit margin percentage before interest and tax would be estimated to increase by less than 1 percentage point for two out of three entities, considering all entities in this sample together. Nonetheless, when analysing and making investment decisions for some individual entities, there would be a material difference in the income statement amounts reported by some lessees under Type A compared to existing operating lease accounting. The profit margin percentage before interest and tax is estimated to increase by more than 1 percentage point for one out of three entities, and more than 2 percentage points for one out of five entities, in this sample. Those differences could be important for some investors and analysts. When assessing the operating performance of an entity or determining enterprise value, it can be important to separate operating and financing elements of the financial statements. This is because investors and analysts often wish to assess the performance of an entity, independently of the financing or ownership structure.

(c) The estimation techniques used commonly by investors and analysts often over-estimate the interest element embedded within the existing operating lease expense.

19. To better assess the variation in effects on individual entities within an industry sector, we have analysed the effects of applying Type A accounting for airlines from one region. The key findings are shown in the following table:

Company reference	Increase in profit margin % before interest and tax (Type A)	Imputed operating lease liability / total assets
Airline 1	0.5%	5%
Airline 2	0.3%	5%
Airline 3	0.5%	10%
Airline 4	1.1%	23%
Airline 5	0.4%	29%
Airline 6	1.8%	48%
Airline 7	1.7%	40%
Airline 8	1.9%	65%
Airline 9	2.8%	108%
Airline 10	3.3%	100%

20. The analysis for these airlines shows that capitalising existing operating leases can have relatively little effect on the reported financial information for some airlines. In contrast, some other airlines would change from having little or no reported leverage to adjusted leverage that significantly exceeds reported equity.

21. There are similar results in terms of the effect on the income statement. Type A accounting has varying effects on each airline's profit margin before interest and tax, depending on the nature and significance of existing operating leases. For example, Airline 8 reported a loss before interest and tax. We would anticipate Airline 8 reporting a profit before interest and tax if it applied Type A accounting to its existing operating leases.

Appendix: Summary of the information provided about 500 entities listed in Europe

Types of business	Number of entities	Total assets ($million) (A)	Future operating lease payments ($million) (B)	Ratio of operating lease commitments to total assets (B/A)
Aerospace & defence	9	266,779	6,242	2.34%
Automobiles & parts	13	1,152,805	26,013	2.26%
Banks	49	33,905,003	81,735	0.24%
Beverages	13	403,068	6,518	1.62%
Chemicals	23	415,694	9,496	2.28%
Construction & materials	16	507,408	16,785	3.31%
Electricity	16	1,023,706	14,899	1.46%
Electronic & electrical equipment	6	87,795	2,435	2.77%
Financial services	19	1,032,811	6,667	0.65%
Fixed line telecommunications	13	572,833	44,614	7.79%
Food & drug retailers	14	343,987	77,223	22.45%
Food producers	11	297,917	12,324	4.14%
Forestry & paper	3	45,528	1,591	3.49%
Gas, water & multiutilities	12	912,448	18,817	2.06%
General industrials	6	259,104	6,752	2.61%
General retailers	7	87,804	34,237	38.99%
Health care equipment & services	9	92,566	7,990	8.63%
Household goods & home construction	9	91,873	1,237	1.35%
Industrial engineering	22	360,333	8,007	2.22%
Industrial metals & mining	10	259,399	3,488	1.34%
Industrial transportation	12	278,215	27,525	9.89%
Life insurance	13	5,195,415	10,523	0.20%
Media	20	270,004	18,907	7.00%
Mining	14	692,240	8,448	1.22%
Mobile telecommunications	11	542,621	41,854	7.71%
Nonlife insurance	19	3,967,370	8,448	0.21%
Oil & gas producers	24	2,252,917	94,956	4.21%
Oil equipment & services	11	137,135	7,702	5.62%
Personal goods	15	271,475	31,658	11.66%
Pharmaceuticals & biotechnology	15	529,197	10,107	1.91%
Real estate investment & services	3	33,439	116	0.35%
Real estate investment trusts	11	168,204	10,185	6.06%
Software & computer services	9	82,847	5,730	6.92%
Support services	19	123,796	10,283	8.31%
Technology hardware & equipment	6	112,439	4,193	3.73%
Tobacco	3	90,794	708	0.78%
Travel & leisure	15	209,529	26,903	12.84%
Total	**500**	**57,076,496**	**705,315**	**1.24%**

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Appendix: Summary of the information provided about 500 entities listed in Europe

Breakdown of the ratio of operating lease commitments to total assets among the 500 entities

Types of business	More than 5%										Less than 5%					
		>75%	50% to 75	20% to 50	10% to 20	9% to 10%	8% to 9%	7% to 8%	6% to 7%	5% to 6%		4% to 5%	3% to 4%	2% to 3%	1% to 2%	Less than 1%
Aerospace & defence	3						1		1	1	6			3	2	1
Automobiles & parts	1									1	12	1	1	2	3	5
Banks	0										49					49
Beverages	0										13		2	1	4	6
Chemicals	2				1				1		21	2	1	6	7	5
Construction & materials	3								2	1	13	2	1	4	4	2
Electricity	2							1	1		14	1		3	2	8
Electronic & electrical equipment	1								1		5		2	1	2	
Financial services	2				2						17	1	1	1	3	11
Fixed line telecommunications	7			1	3	1	1	1			6		1		3	2
Food & drug retailers	10		1	3	2	1	1	1		1	4	1			1	2
Food producers	3			1				2			8	2		3	2	1
Forestry & paper	0										3		3			
Gas, water & multiutilities	1									1	11	1	1	2	4	3
General industrials	0										6	1	1	1	2	1
General retailers	7	2	2	1	1	1					0					
Health care equipment & services	4				1	1			1	1	5	2		1	2	
Household goods & home construction	0										9	1			2	6
Industrial engineering	2								1	1	20	2	5	4	5	4
Industrial metals & mining	0										10		1		3	6
Industrial transportation	8			3	4					1	4					4
Life insurance	0										13					13
Media	9	1			4	1	2			1	11	2	2	1	4	2
Mining	0										14		2	1		11
Mobile telecommunications	4			1	2					1	7	3		1	2	1
Nonlife insurance	0										19			1	2	16
Oil & gas producers	6				2		2		1	1	18		1	1	7	9
Oil equipment & services	8				4	2	1		1		3				1	2
Personal goods	13		1	2	9				1		2				1	1
Pharmaceuticals & biotechnology	4							2		2	11		1	2	5	3
Real estate investment & services	0										3					3
Real estate investment trusts	3				2				1		8		1			7
Software & computer services	7				2	2	3				2		2			
Support services	11			1	4	1	3	1	1		8	1	4		1	2
Technology hardware & equipment	1					1					5	1	2	1	1	
Tobacco	0										3				2	1
Travel & leisure	12		2	4	1		1	1	3		3		1		1	1
Total	**134**	**3**	**6**	**17**	**44**	**11**	**15**	**9**	**16**	**13**	**366**	**24**	**36**	**40**	**78**	**188**
		0.6 %	**1.2 %**	**3.4 %**	**8.8 %**	**2.2 %**	**3.0 %**	**1.8 %**	**3.2 %**	**2.6 %**		**4.8 %**	**7.2 %**	**8.0 %**	**16 %**	**38 %**
	27%										**73%**					