Tuesday 30 September 2014
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Education session: Leases project update

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Education session:
Leases project update

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International Financial Reporting Standards

The Leases Project

September 2014

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

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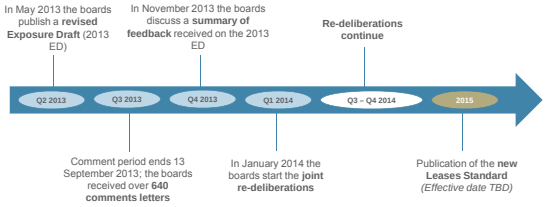
Project status



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The need for change

- Leases create assets and liabilities
- Most leases are not reported on the balance sheet
- Leverage of heaviest users of operating leases[1] understated by:
  - 20% Europe
  - 23% N America
  - 46% Asia Pacific
- Huge variation across and within industries

(1) 950 companies in Europe, North America and Asia Pacific each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

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A thorough and measured approach

US SEC (2005)[1]: 'The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers…
[I]t is likely that a project on lease accounting would generate significant controversy; many issuers see leasing as an attractive form of financing asset acquisition in part because leases can be structured so as to avoid recording debt…a project on lease accounting is likely to take a significant amount of time as well as…resources. Nonetheless…the potential benefits in terms of increased transparency of financial reporting would be substantial enough to justify the time and effort required.'

- We have carefully considered the views of interested parties
  - Discussion Paper and 2 Exposure Drafts over past 8 years
  - Hundreds of outreach meetings

(1) Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

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A lack of comparability

	Industry entity 1		Industry entity 2	
	Reported	Proposals[1]	Reported	Proposals[1]
Total property, plant and equipment	16,908	19,926	15,748	24,020
Non-current liabilities	13,232	16,567	9,615	18,320
Equity	6,719	6,402	5,604	5,171
Ratio of non-current liabilities to equity	2.0:1	2.6:1	1.7:1	3.5:1

(1) Proposals are estimates using various assumptions about the discount rate and average lease term of leases held by each entity.

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And a lack of information

Retailer	Operating lease commitments (undiscounted) [1]	Reported debt [1]	Operating lease commitments as % of reported debt
Circuit City (US)	$4,537M	$50M	9074%
Borders (US)	$2,796M	$379M	738%
Woolworths (UK)	£2,432M	£147M	1654%
HMV (UK)	£1,016M	£115M	883%
Clinton Cards (UK)	£652M	£58M	1124%

(1) Based on financial information available in the 5 years before the company entered Chapter 11 (US) or liquidation (UK).

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Most investors make estimated adjustments

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- Use rough estimation techniques (eg multiple of rent expense)
- Liabilities of individual companies often overstated but some understated

950 companies[1]	Reported	Adjusted on present value basis	Adjusted on multiple of 8 basis
Long-term (LT) debt *(in millions of dollars)*	5,623,307	7,080,412	7,673,513
LT debt to total assets	16%	19%	20%
LT debt to equity	56%	71%	77%

(1) 950 companies in Europe, North America and Asia Pacific, each with estimated operating lease liabilities of >$300M (discounted basis). Based on 2012 financial statements. Present value basis estimated using average cost of borrowing in each region (excluding banks). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

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Companies also provide lease-adjusted information—a sample

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Airlines	Retail		Hotels	Transport and courier
Air France – KLM	Ahold	AutoZone	Accor	A.P. Moller – Maersk Group
Alaska Airlines	Foot Locker	Home Retail Group (Argos, Homebase)	Whitbread (Premier Inn)	Deutsche Post
Delta Airlines	Kingfisher (B&Q, Castorama)	Nordstrom		
Easyjet	Sainsbury's	Whole Foods		
Emirates				
SAS Airlines				

Oil and gas	Construction
Shell	Hochtief
Statoil	Travis Perkins

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Investor support for the project

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- Extensive outreach
  - In 2013, 270 investors and analysts around the world
- Majority support recognition on balance sheet—measured to reflect contractual commitments
- Disclosure is not enough[1]

(1) See CMAC formal recommendation to the IASB: http://www.ifrs.org/About-us/IASB/Advisory-bodies/CMAC/Documents/CMAC-Formal-Recommendation-on-Lessee-accounting-October-2013.pdf

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Convergence with the FASB

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Converged decisions

- Leases reported on-balance sheet
- Definition of a lease
- Measurement of lease liabilities

Different

- Lease expenses in income statement and cash flows in cash flow statement

- **In practice, little difference in amounts reported for many companies**

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IASB lessee model

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- Useful information
  - Most investors think leases create debt-like liabilities
  - Link between balance sheet and income statement important for analyses, eg return on capital
- Strong conceptual basis
  - All leases contain rights of use
- Cost and complexity
  - No difference in liability measurement caused by difference in lease expense
  - IASB model:
    - Can use fixed asset systems for lease asset
    - No lease classification

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Benefit of separating interest expense

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- Many investors adjust the income statement using rough estimation techniques (eg interest = 1/3 rent expense, depreciation = 2/3 rent expense; or EBITDAR)
- Estimated effects of IASB lessee model on operating profit:

950 listed companies[1]	Increase in operating profit margin %
62%	< 1%
19%	1 – 2%
13%	2 – 5%
4%	5 – 10%
2%	> 10%

(1) 950 companies in Europe, North America and Asia Pacific each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

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Illustration—lessee model

Three companies lease an identical truck for the same 4-year period:
Company 1—pays €50,000 upfront
Company 2—pays €60,000 in equal amounts over 4 years
Company 3—pays €53,000 at the end of year 1

Difference in total payments relates solely to difference in timing of payments.

Accounting over 4-year lease term		Company 1	Company 2	Company 3
	Lease asset—cost	€50,000	€50,000	€50,000
IASB	Operating expense	€50,000	€50,000	€50,000
	Interest expense	€0	€10,000	€3,000
FASB	Operating expense	€50,000	€60,000	€53,000

Same expense reflecting use of an identical asset that cost the same amount

Different even though using an identical asset that cost the same amount

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Decisions to reduce cost and complexity

IASB responding to feedback in redeliberations:

- Single lessee model
- Exemption for short-term and small asset leases
- Portfolio application
- Simplified measurement of liability
  - Exclude variable payments and most optional payments
- Simplified separation of lease and non-lease payments
- In essence, no change to existing lessor accounting

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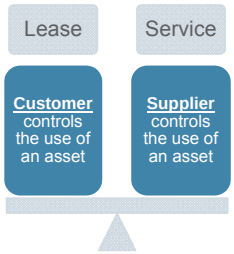
Lease vs service



- Clear principle
- Vast majority of cases—straight forward
- Leases different from service / executory contracts
  - Asset not obtained at start of typical service / executory contract
- Separate services provided with leases

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Going forward

- IASB and FASB will continue to re-deliberate jointly
- Publication of final standard—2015

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Thank you

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What some preparers say…

TIME WARNER CABLE: 'While [we] support the IASB and FASB's goal of improving lease accounting by requiring assets and liabilities that arise from leases to be recognized…we believe that the widely criticized shortcomings of the current lease accounting model…can be better addressed using a single and consistent model for all leases…[We] believe that the effective interest method is relevant to the liabilities associated with all leases…In addition, the two-model approach proposed in the Exposure Draft will result in an annual depreciation expense for the Type B asset that must increase over time…We believe, based on our experience, that this treatment will create a disconnect between the recorded depreciation of the leased asset and its actual diminution in value, which generally occurs on a more straight-line basis.'

MTN GROUP: '[The company] is supportive of the IASB lease project. In particular, [the company] believes that the right-of-use model, if applied consistently for all leases other than short term leases, has the potential to improve the quality of financial reporting…We propose that only one lease model should be followed, that of Type A, to reduce inconsistent treatment in the statements of profit or loss and financial position brought about by Type B, to reduce complexities in the application as well as to improve consistency in lease accounting.'

DEUTSCHE TELEKOM: 'The one line operating expense result is not based on conceptually sound accounting concepts and should not be adopted as proposed...We therefore propose that a lessee should account for all leases, except short-term leases, according to the principles outlined in this Exposure Draft for Type A leases...Aside from the conceptually superior accounting basis, this result would also reduce the complexity and cost for lessees.'

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What some preparers say…

BHP BILLITON: '[W]e support the initiative to achieve proper recognition of assets and liabilities arising from leasing arrangements…it is critical that a simpler (and single) model for both lessees and lessors be pursued to better demonstrate the cost / benefit equation…in principle we agree with most of the recognition, measurement and presentation requirements relating to Type A leases however we do not believe that a different method is warranted for Type B leases.…Our view is that once the right of use asset is recognised it should be measured independently from the lease liability.'

AIR CANADA: 'We agree that an entity should recognize its assets and liabilities related to leases…The amortization of the right-of-use asset under Type B leases has no basis in the conceptual framework. Users of financial statements will not understand why amortization on the right-of-use asset increases in later years, which is typically contrary to the benefits derived from property and equipment as maintenance and betterment costs increase as the asset ages…the overriding comment is to abolish the dual accounting model and amend the proposals to provide for one accounting model based on the Type A lease accounting model.'

GENERAL MOTORS: '[W]e strongly support the overall goals of the Boards' joint leasing project…including the on-balance sheet recognition of assets and liabilities related to all leasing transactions and the simplification of existing GAAP…We also believe that lessees should be required to apply an approach similar to the Type A model…for all leases as this method best captures the true nature of leases which inherently all contain a financing element.'

SHELL: 'We do not agree with the proposal to introduce the Type B lease accounting model, for two reasons. Firstly, we are concerned by the conceptual flaws of this model...Secondly, we fear that the introduction of two accounting models will bring unnecessary complexity to the accounting for, and reporting of, leases.'

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What some investors say…

Securities Analysts Association of Japan: '[We] firmly believe that all lease assets and liabilities should be put on a lessee's balance sheet.'

Capital Markets Advisory Committee: '…while a disclosure-only solution might be acceptable to expert users of financial statements, it would not be helpful to the majority of investors who require financial statements to provide them with clear information from the outset.'

European Federation of Financial Analysts Societies: '…lessees by signing a lease contract are committed to future payments of rentals which in turn increase their financial risks. Thus, leases giving rise to a financial liability should be incorporated onto the balance sheet…Lessee accounting should reflect the right to consume an asset and to settle the related liability...Lease payments should be allocated to both interest and depreciation even for Type B leases becoming therefore an obligation of the lessee to the lessor.'

Association of Swedish Financial Analysts: 'Leases…create assets and liabilities and should be reported on a lessee's balance sheet…The income statement effects should include amortization…as well as interest.…From an estimation perspective, the capitalized rents have very little in common with operational liabilities [which are] non-interest bearing in nature…Since the future cash outflows are discounted, the most natural label in the balance sheet is interest bearing/financial.'

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What some investors say…

CFA Institute: 'The creation of Type B leases raises a question regarding the usefulness of the financial statement balances…There is no conceptual justification for inextricably linking the subsequent measurement of the right-of-use asset and liability to pay lease rentals for Type B leases…In addition, income statement related metrics such as…EBIT and…EBITDA are widely used by various users as performance and valuation measures. These users assume that there is an interest component for all leases…Without an interest versus amortization disaggregation for Type B leases, users will be unable to obtain comparable EBIT and EBITDA across all companies. These will also introduce a distortion to the performance analysis and valuation of companies that have Type B leases.'

Standard & Poors: 'In our view, the accounting distinction between operating leases…and capital leases…is substantially artificial. In both cases, the lessee contracts for the use of an asset from a lessor, entering into a debt-like obligation to make periodic rental payments…We view this proposed change [to the balance sheet] as a significant improvement in lease accounting…We do not support drawing any distinctions between different leases…which we believe is unnecessarily complex and not decision-useful to our analysis. We would prefer a single lease accounting model for lessees..akin to the current proposals for Type A leases.'

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