August 2014

Project Update

Leases

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Leases

What is the purpose of this document?

This document provides an update on the most important tentative decisions reached on the Leases project during the first half of 2014, explains the IASB's reasons for reaching those decisions and explains the remaining work to be done in completing the project.

Project status

Leases is an important project that the IASB is undertaking jointly with the FASB.

The IASB and the FASB (the boards) jointly published a revised Exposure Draft *Leases* (the 2013 ED) in May 2013. The boards have received extensive feedback on their proposals, and have heard a broad range of views. During the first half of 2014, the boards have redeliberated and reached tentative decisions on many aspects of the project. In the second half of 2014 the boards will continue their joint redeliberations and will decide upon the effective date of the new *Leases* Standard.

The IASB expects to issue a new *Leases* Standard in 2015.

1—The need for change

All leases create assets and liabilities

Leases provide a source of financing. A lessee obtains an asset and incurs a liability when it enters into a lease. This view is held not only by the IASB but also by the majority of investors and analysts, many regulators, standard-setters and accounting firms, and some preparers.

Contrary to that view, at present, most leases are not reported on a lessee's balance sheet.

The significance of the missing information varies by industry and region and between entities. However, for many lessees, the effect on reported leverage can be substantial.

Long-term liabilities of heaviest users of off balance sheet leases[1] ***understated*** by:

20% Europe
23% North America
46% Asia Pacific

Investors and analysts frequently adjust a lessee's balance sheet

As required by existing accounting standards, a lessee provides information about off balance sheet leases in the notes to its financial statements. That information is, however, limited in content.

Most investors and analysts that we consulted use that information to estimate assets and liabilities arising from off balance sheet leases. Some try to estimate the present value of future lease payments. However, because of the limited information that is available, many others use techniques such as multiplying the annual lease expense by 8 in order to assess, for example, total leverage and the capital employed in operations.

These adjustments are made by more sophisticated investors and analysts. Many investors, however, cannot make adjustments—they are reliant on data sources such as data aggregators when screening potential investments or making investment decisions.

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

The table below shows how the estimate of long-term liabilities can vary based on the information available and the techniques used based on a sample of 950 companies.[2]

	Reported	Adjusted on present value basis	Adjusted on multiple of 8 basis
Long-term (LT) debt (In millions of US 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%

Some investors and analysts also adjust a lessee's income statement

Most investors and analysts that we consulted view leases as creating 'debt-like' liabilities. Accordingly, many think that lease payments incorporate an interest component.

Under existing accounting standards, a lessee presents lease expenses related to off balance sheet leases within operating expenses.

When assessing a lessee's performance, some investors and analysts adjust a lessee's income statement, increasing the reported operating result by removing an estimate of interest on off balance sheet leases from operating expenses. Others remove the entire off balance sheet lease expense from the operating result (and adjust for depreciation, amortisation and interest), arguably to improve comparability between entities that own assets and those that lease them.

Most investors and analysts want to adjust for off balance sheet leases.

However, the adjustments made by investors and analysts can be incomplete or inaccurate, resulting in over- or under-estimation of a lessee's assets, liabilities, interest expense and operating result.

Some do not have the information needed to make adjustments.

2 950 companies in Europe, North America and Asia-Pacific, each with estimated operating lease liabilities of greater than $300m (discounted basis). Data estimated using information obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

Some lessees *choose* to provide 'non-GAAP' information that adjusts reported figures to reflect off balance sheet leases

Why?

Some of the lessees who make such adjustments have told the IASB that they do this either because they view leases as a significant source of financing or are responding to requests for that information from investors, analysts or other users of their financial statements.

How?

Lessees adjust the reported figures by capitalising off balance sheet lease commitments. Some also apportion the off balance sheet lease expense into interest and amortisation, or apportion the off balance sheet lease cash flows into interest and principal repayments.

Who?

Lessees who adjust reported figures include: Air France-KLM, Alaska Airlines, Easyjet, Emirates, Delta Airlines, SAS Airlines, Shell, Statoil, Kingfisher (Castorama, B&Q), Foot Locker, Ahold, Sainsbury's, Whole Foods, Home Retail Group (Argos, Homebase), Accor, Whitbread (Premier Inn), Deutsche Post, Travis Perkins, AutoZone, Nordstrom, AP Moeller Maersk, Hochtief.

A lack of comparability

The existing accounting for leases makes comparisons between entities difficult

The table below sets out a real-life comparison of two entities in an industry that uses property, plant and equipment intensively.

Entity 2 leases about 70 per cent of its equipment and Entity 1 less than 10 per cent.

Important information used by investors and analysts (for example, total assets and long-term liabilities) can be significantly affected by the off balance sheet treatment of leases.

For example, the table below contrasts the figures reported by the entities with the figures adjusted for the effects of off balance sheet leases. The reported figures show that Entity 1 has higher leverage and a higher asset base compared to Entity 2, when in fact the opposite is true, taking into account the off balance sheet leases.

The absence of information about leases on the balance sheet means that investors and analysts cannot properly compare companies without adjustments.

	Industry Entity 1		Industry Entity 2	
	Reported	Proposals[3]	Reported	Proposals[3]
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

3 The figures included in the proposals columns are estimates using various assumptions about the discount rate and average lease term of leases held by each entity.

And a lack of information

It is not only difficult to make comparisons–there is also a lack of information

The exclusion of lease assets and liabilities from the balance sheet can lead to the presentation of an incomplete picture of the financial position of a lessee.

For example, for a sample of retail chains that ultimately went into liquidation, the table below shows the extent of off balance sheet lease commitments. This illustrates how vastly different the leverage and operating flexibility of lessees can be when the effect of off balance sheet lease commitments is taken into account.

The liabilities of these companies range from 7 times to more than 90 times higher than the debt that they reported, when taking into account off balance sheet lease commitments.

Retailer	Operating lease commitments (undiscounted)[4]	Reported debt[4]	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%

4 Based on averaged published financial statements data available in the 5 years before the entity entered Chapter 11 (US) or liquidation (UK).

2—A thorough and measured approach

The project proposes a substantial change to the accounting for leases

In more developed regions, approximately 50 per cent of listed entities report material off balance sheet lease commitments.[5] The proposed changes to lease accounting will significantly improve the transparency of information about those off balance sheet leases.

The IASB realises that such a big change in accounting, which would affect many entities, requires careful consideration. The IASB therefore recognises the need to understand and carefully consider the views of interested parties.

As a result the IASB has proceeded cautiously with the project, going well beyond its due process requirements. It has sought feedback at each stage of the project and considered that feedback when revising the proposals.

Particular efforts have been made to undertake outreach activities that enable a broad range of views to be heard including the views of investors and analysts. Since 2009, the IASB has undertaken three public consultations on its proposals and held hundreds of meetings, round tables and other outreach activities.

Over the past 8 years

- 2009 Discussion Paper (the 2009 DP)
- 2010 Exposure Draft (the 2010 ED)
- 2013 Revised Exposure Draft (the 2013 ED)
- Hundreds of outreach meetings with investors, analysts, preparers, regulators, standard-setters, accounting firms and others

In 2013 the IASB spoke to approximately 270 investors and analysts around the world, conducted preparer fieldwork meetings and held public round tables[6]

5 Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.
6 The IASB and the FASB conducted those meetings with interested parties jointly.

3—The IASB's response to the feedback

This section summarises the most important tentative decisions reached by the IASB in its redeliberations up to July 2014.

The IASB has focused on the benefits of information provided to investors and analysts, but at the same time has considered the cost and complexity of the proposed change to the accounting for leases.

This is because, regardless of views on the recognition of leases, the majority of lessees are concerned about the cost associated with implementing the proposals, particularly for large volumes of small items.

Leases reported on the balance sheet

All leases on the balance sheet

The boards have both tentatively decided that a lessee would be required to recognise assets and liabilities arising from all leases, with some exemptions. The model reflects that, at the start of a lease, the lessee obtains a right to use an asset for a period of time, and the lessor has provided or delivered that right.

A majority of investors and analysts that we consulted supported the recognition of leases on a lessee's balance sheet.

Some have suggested merely improving disclosures. However the boards have concluded that this would be insufficient to address the identified deficiencies in existing lease accounting.

In particular the asymmetry of information used when making investment decisions is a concern because some investors adjust for off balance sheet leases (using varied techniques) whereas others do not.

The Capital Markets Advisory Committee, an investor advisory body to the IASB, stated '*...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.*'[7]

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7 See CMAC formal recommendation to the IASB here http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/archive/Pages/CMAC-Recommendation-October-2013.aspx

Are there any exemptions?

Yes. In response to concerns expressed about cost and complexity, a lessee is not required to recognise assets and liabilities for leases of 12 months or less. To address concerns about the costs to apply the proposals to large volumes of small items, the IASB is also considering an exemption for leases of small assets (such as laptops and office furniture).

Recognition of lease expenses

The boards have made different tentative decisions regarding the recognition and presentation of lease expenses in a lessee's income statement.

The IASB has tentatively decided to propose a single lessee model that would require the recognition of interest and amortisation for all leases recognised on a lessee's balance sheet.

The FASB has tentatively decided to propose a dual model that retains the existing distinction between finance leases (ie leases that are in-substance purchases) and operating leases. This model would result in no change to a lessee's income statement, but recognises all leases on the balance sheet.

Why return to a single lessee model?

Feedback received on the lessee model has been mixed throughout the project. Some view all leases as financing transactions. Others view almost no leases as financing transactions. For others, the economics are different for different leases.

The boards originally proposed a single lessee model in the 2009 DP and 2010 ED. Some agreed with that model, while others did not.

In response to requests from some to better reflect the economic differences between different leases, the boards proposed a dual model in the 2013 ED. That model distinguished between most real estate leases and other leases, and attempted to identify real economic differences between leases (for example, many investors supported that distinction because, in general, they view real estate leases as economically different from other leases).

The main feedback received on the 2013 ED was that the dual model proposed was too complex.

Some suggested reverting to a single model. Others suggested a dual model that retained the existing distinction between operating and finance leases.

In practice, the difference in the IASB and FASB positions is expected to result in little difference for many lessees for portfolios of leases. So why reach different decisions?

In reaching its tentative decisions, the IASB carefully considered the information that would be provided to investors and analysts, as well as conceptual considerations and operational cost and complexity.

Information for investors and analysts: link between the balance sheet and the income statement

On the basis of feedback received, the IASB concluded that a model that separately presents interest and amortisation for all leases recognised on the balance sheet would provide information that is useful to the broadest range of investors and analysts. This is because most investors and analysts consulted think that leases create assets and *debt-like* liabilities for a lessee. The model is easy to understand—a lessee recognises fixed assets and financial liabilities, and corresponding amounts of amortisation and interest. It also avoids any structuring that might arise from having different accounting for different leases, which was a concern expressed by some investors and analysts.

Conceptual considerations: all leases provide a right of use

The IASB is of the view that all leases result in a lessee obtaining the right to use an asset and the provision of financing, regardless of the nature or remaining life of the underlying asset. Accordingly, the IASB concluded that all leases should be accounted for in the same way.

Some feedback received on the 2013 ED indicated that it would be difficult to understand why for some leases there would be (a) no amortisation or depreciation of the lease asset recognised on the balance sheet and (b) no interest on the lease liability (a financial liability) recognised on the balance sheet. Some questioned this accounting because a lessee would measure the lease asset as a balancing figure.

Operational cost and complexity: single model

On the basis of feedback received, the IASB thinks that the cost of accounting for leases under both models is broadly similar. This is because the most significant costs for lessees arise from recognising leases on the balance sheet—the difference between the IASB's and the FASB's lessee model does not result in any difference in the measurement of lease liabilities.

However, the IASB's model would no longer require a lessee to classify leases and, thus, reduces complexity.

In addition, it would always result in a lessee amortising the lease asset in the same way as other fixed assets. Consequently, a lessee could use existing fixed asset information systems to account for all lease assets.

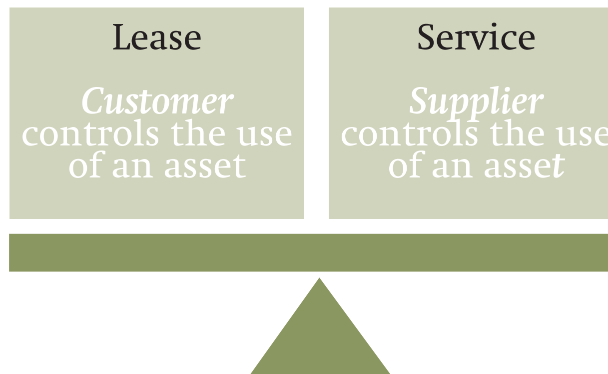
The IASB could be seen as codifying best practice by requiring leases to be recognised on a lessee's balance sheet and interest expense to be recognised in the income statement.

Definition of a lease

What is a lease? What is a service?

Under existing standards, the accounting for off balance sheet leases and services is similar. Under the new *Leases* Standard, this will change. Consequently, the distinction between a lease and a service is critical, because that distinction would determine whether a lessee recognises assets and liabilities.

The principle is clear—a lease exists when the *customer* controls the use of an identified asset; a service exists when the *supplier* controls the use of an asset.



In the vast majority of cases, this assessment is straightforward. However, in some scenarios the distinction can be difficult to make and would require judgement.

Feedback received on the proposed definition of a lease in the 2013 ED was generally supportive, but many requested additional clarity about how to apply the principle. In response to that feedback, some aspects of the guidance will be changed to make it easier to determine whether a contract contains a lease.

Some raised concerns that when a lease contract contains some services, those services may be inappropriately included within the scope of lease accounting. Consequently, some suggested changing the definition so that contracts that include leases and a substantial proportion of services would be accounted for entirely as services. This approach was not adopted because (a) it could result in an entity that has the right to use an asset *not* recognising that right of use (and corresponding liability) in many scenarios; and (b) it would be complex to apply.

Nonetheless, the boards agree that the objective is not to include service components in lease accounting. Consequently, service components of contracts would be separated from lease components—thus the new requirements would apply only to lease components. In response to feedback received on the 2013 ED, the boards would allow lessees to use estimates to separate payments between lease and service components in a contract.

Measurement of lease liabilities

How does a lessee measure lease assets and liabilities?

A lessee would measure lease assets and liabilities at the present value of future lease payments. Lease assets also include any costs directly related to entering into the lease.

In response to concerns about cost and complexity, the boards have simplified the measurement of lease assets and liabilities. Consequently, variable payments and most optional payments are excluded from that measurement. The boards have also simplified the reassessment requirements compared to those proposed in the 2013 ED, thereby reducing the cost and complexity of application.

In addition, the boards have clarified that a lessee can apply the requirements to a portfolio of similar leases, rather than to each individual lease.

Cash flow presentation

Leases are financing activities

To retain the link between the balance sheet, income statement and cash flow statement, a lessee would classify: (a) cash payments for the principal portion of the lease liability within financing activities and (b) cash payments for the interest portion of the lease liability in accordance with the requirements relating to other interest paid.

Lessor accounting

Lessor accounting unchanged

Feedback received on the 2013 ED, including feedback from many investors and analysts, indicated that the costs of changing lessor accounting would outweigh the benefit of doing so at this time.

Although a 'nice to have', most constituents indicated that it is not essential to have symmetrical lessee and lessor accounting models. In response to that feedback, the boards have tentatively decided, in essence, to leave lessor accounting unchanged.

Substantial convergence with the FASB

- Balance sheet recognition of leases—the main focus of the project
- Definition of a lease
- Measurement of lease liabilities
- Lessor accounting unchanged

4—What remains to be done?

Disclosure and transition

In the second half of 2014 the boards will discuss lessee disclosures and transition requirements. For both of these topics, the boards will reconsider opportunities to reduce the cost and complexity of the requirements.

The boards will continue to discuss the project jointly, with the aim of minimising any differences between IFRS and US GAAP.

The IASB expects to issue a new *Leases* Standard in 2015.

Further information

The boards' redeliberations of the proposals will continue to take place in public meetings. Information about these public meetings will be available on the IASB's website.

Exposure documents and the comment letters are also available on the IASB's website.

To stay up to date with the latest developments of this project and to sign up for email alerts, please visit the project homepage on http://go.ifrs.org/Leases.

Important information

This Project Update has been compiled by the staff of the IFRS Foundation as guidance for interested parties. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the IASB and should not be considered authoritative in any way. The content of this Project Update does not constitute any form of advice or opinion.

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