

March 2015

Project Update

Leases: Practical implications of the new *Leases* Standard

Leases

What is the purpose of this document?

This document describes the IASB's lessee accounting model and compares it to the FASB's model, highlighting the similarities and differences between them. In response to requests from stakeholders, it also provides an overview of some of the possible effects of the forthcoming changes to lessee accounting, and of the work that the IASB has undertaken to assess those effects.¹

Project background

The IASB and the FASB (the Boards) are working together to improve the accounting for leases. To meet this objective, the Boards think that a customer (lessee) leasing assets should recognise assets and liabilities arising from those leases (including leases that are off balance sheet today).

The Boards jointly published a revised Exposure Draft *Leases* (the 2013 ED) in May 2013. The Boards received extensive feedback on their proposals, and have heard a broad range of views. Since March 2014 the Boards have redeliberated almost all aspects of the project. They will decide upon the effective date of the new *Leases* Standard in the next few months.

The IASB plans to issue the new *Leases* Standard before the end of 2015.

¹ This document does not contain an assessment of all possible relevant effects of the changes to lessee accounting. The IASB intends to publish a comprehensive effects analysis when it issues the new *Leases* Standard.

1—The IASB lessee accounting model

This section provides an overview of the lessee accounting model developed by the IASB based on decisions to date.² For further information about the IASB's reasons for reaching key decisions, please refer to [Project Update: Leases](#).

This section also provides an overview of the FASB's lessee accounting model, summarises the similarities and differences between the models, and describes the expected effects of both models on the financial information reported today by lessees under existing accounting requirements.

In essence for all leases, the IASB model requires a lessee to:

- (a) recognise lease assets and liabilities on the balance sheet, initially measured at the present value of unavoidable lease payments;
- (b) recognise amortisation of lease assets and interest on lease liabilities over the lease term; and
- (c) separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

The FASB lessee accounting model

In essence, the FASB model requires a lessee to do the following:

- (a) for leases already recognised on the balance sheet today (ie existing finance/capital leases), account for them as for the IASB model; and*
- (b) for leases not recognised on the balance sheet today (ie existing operating leases), (i) recognise lease assets and liabilities (measuring lease liabilities as for the IASB model), (ii) recognise a single lease expense typically on a straight-line basis over the lease term and (iii) present total cash paid within operating activities.*

² Any decisions taken by the IASB at public Board meetings are tentative until it has formally balloted on a consultation document or an IFRS. This document uses 'decided' and 'decisions' to refer to the tentative decisions of the IASB and the FASB as at 1 March 2015.

Summary of similarities and differences for lessee accounting

		Existing ON balance sheet leases		Existing OFF balance sheet leases		
		IASB	FASB	IASB	FASB	
Balance sheet						
1	Recognition	All leases on balance sheet	✓	✓	✓	✓
		Exemption for short term leases	✓	✓	✓	✓
		Exemption for small asset leases	✓	—	✓	—
2	Measurement	Lease liabilities on a discounted basis	✓ ³	✓ ³	✓ ³	✓ ³
		Initial lease asset = lease liability	✓	✓	✓	✓
		Amortisation of lease assets	Typically straight-line	Typically straight-line	Typically straight-line	Typically increasing ⁴
4	Presentation	Lease liabilities	IAS 1	Separate presentation (from existing off balance sheet leases)	IAS 1	Separate presentation (from existing on balance sheet leases)
		Lease assets	PPE <i>or</i> own line item		PPE <i>or</i> own line item	
Income statement						
6		Operating costs	Amortisation	Amortisation	Amortisation	Single expense
		Finance costs	Interest	Interest	Interest	—
Cash flow statement						
7		Operating activities	Interest ⁵	Interest	Interest ⁵	Interest and principal
		Financing activities	Principal	Principal	Principal	—

3 Lease liabilities are measured in the same way under the IASB model and the FASB model, except that inflation-linked payments are reassessed when those payments change under the IASB model, but are not under the FASB model.

4 Lease assets are measured at an amount that achieves the recognition of a single lease expense typically on a straight-line basis.

5 Under IFRS, interest payments can be presented within either operating or financing activities.

Balance sheet

1 Recognition on the balance sheet

The IASB decided that lessees should be required to recognise assets and liabilities arising from all leases on the balance sheet. The model reflects that, at the start of a lease, the lessee obtains the right to use an asset for a period of time and has an obligation to pay for that right.

Are there any exemptions?

Yes. In response to concerns expressed about cost and complexity (and, in particular, the costs to apply the requirements to large volumes of small assets), the IASB decided not to require a lessee to recognise assets and liabilities for (a) leases of 12 months or less (short-term leases), and (b) leases of small assets (such as laptops and office furniture).

2 Measurement of lease liabilities

A lessee can obtain flexibility in a lease. For example, leases often include extension options or break clauses, and can include payments that vary based on sales or the use of an asset.

The IASB decided that a lessee would measure lease liabilities at the present value of future lease payments. However, to reflect the flexibility obtained by a lessee and to reduce complexity, lease liabilities include only economically unavoidable payments and there is a simplified approach to deal with variability in payments.⁶

3 Measurement of lease assets

A lessee would measure lease assets, initially at the same amount as lease liabilities, and also include costs directly related to entering into the lease. Lease assets would then be amortised in a similar way to other assets such as property, plant and equipment, which would often be expected to result in straight-line amortisation over the lease term.

Effects on the balance sheet

↑ Lease assets

↑ Financial liabilities

For lessees that currently have material off balance sheet leases, the most significant effect of the new *Leases* Standard will be an increase in lease assets and financial liabilities.

Accordingly, there will be a change to key financial ratios derived from a lessee's assets and liabilities (for example, leverage and performance ratios).

The Retailer, Airline and Distributor examples on pages 17–23 of this document illustrate this.

⁶ Lease liabilities include fixed payments (including inflation-linked payments), and only those optional payments that the lessee is reasonably certain to make. Lease liabilities exclude variable lease payments linked to use or sales.

Effects on the balance sheet

↓ Equity

The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity compared to today for lessees with material off balance sheet leases. This is similar to the effect on reported equity that arises today from financing the purchase of an asset, either through an on balance sheet lease or a loan.

The actual effect on a lessee's reported equity will depend on the lessee's leverage, the terms of its leases and the ratio of lease liabilities to equity (which in turn depends on how the lessee finances its operations).

The examples on pages 17–23 of this document illustrate this.

Similarities and differences: IASB vs FASB

The Boards have reached the same decisions on the following important aspects of the project:

- (a) the recognition of lease assets and liabilities;*
- (b) the definition of a lease; and*
- (c) the measurement of lease liabilities.⁷*

The same population of leases is put on the balance sheet by both Boards except that the IASB allows 'small asset' leases to be exempt from recognition.⁸

As a result, the most significant effect of applying the new Leases Standard—ie the increase in financial liabilities and the measurement of those liabilities—will be similar for most IFRS and US GAAP lessees.

Regarding existing off balance sheet leases, differences arise between the models in respect of the measurement of lease assets and, consequently, equity. Under the FASB model, a lessee generally amortises lease assets more slowly in the earlier years of a lease than under the IASB model (where, typically, the amortisation of lease assets is on a straight-line basis).

Accordingly, the IASB expects the carrying amount of lease assets, as well as reported equity, to be higher under the FASB model than under the IASB model, although those effects are not expected to be significant for most entities (Distributor example on pages 22–23 illustrates this). Retailer and Airline examples on pages 18–21 illustrate the expected effects for entities with significant off balance sheet leases.

⁷ See footnote 3.

⁸ Because small asset leases are expected to be not material for most lessees, the IASB does not expect any significant differences in the amounts recognised by IFRS and US GAAP lessees in this respect.

4 Presentation of lease liabilities

IFRS already specifies requirements for the presentation of financial liabilities in IAS 1 *Presentation of Financial Statements*. The IASB decided that a lessee would present lease liabilities on the balance sheet in accordance with those requirements as for other financial liabilities. Consequently, a lessee would present lease liabilities as a separate line item, or would split total lease liabilities into more than one line item based on particular characteristics, if that were relevant to understanding the lessee's financial position. A lessee would also split lease liabilities into current and non-current portions, based on the timing of payments.

Similarities and differences: IASB vs FASB

The Boards have both concluded that lease liabilities meet the definitions of financial liabilities in IFRS and US GAAP.

Both Boards have also decided not to prescribe any particular presentation for lease liabilities, except that the FASB decided to require a lessee to present lease liabilities relating to existing on and off balance sheet leases in different line items. In contrast an IFRS lessee would make this distinction (or a more relevant one) if that were relevant to an understanding of its financial position.

5 Presentation of lease assets

The IASB decided that a lessee would present lease assets on the balance sheet:

- (a) together with owned property, plant and equipment (if not presented as a separate line item); or
- (b) as their own line item(s) if that were relevant to understanding the lessee's financial position.

This is because many lessees use owned assets and leased assets for the same purpose and derive similar economic benefits from their use.

Income statement

6 Single lessee model

The IASB model requires a lessee to account for all leases recognised on the balance sheet in the same way. This is because the IASB views all leases as resulting in a lessee obtaining the right to use an asset at the start of the lease and (if payments are made over time) also obtaining financing.

Consequently, a lessee would always recognise and present (a) amortisation of lease assets separately from (b) interest on lease liabilities.

The model is easy to understand—a lessee recognises assets and financial liabilities relating to its leases, and corresponding amounts of amortisation and interest.

This reduces complexity in financial statements, which makes them easier for investors to understand. It also allows comparisons to be made between those who lease assets and those who borrow to buy assets.

Effects on the income statement

- ↑↑ EBITDA
- ↑ Operating profit *and* finance costs
- ↔ Profit before tax

For lessees that currently have material off balance sheet leases, the IASB model will result in higher profit before interest (eg operating profit) compared to the amounts reported today and under the FASB model.⁹

This is because, under the IASB model, a lessee will present the implicit interest in former off balance sheet lease payments as part of finance costs whereas, today, the entire off balance sheet lease expense is included as part of operating costs.

The size of the increase in operating profit, and finance costs, will depend on the significance of leasing to the lessee, the length of its leases and the discount rates applied.

The examples on pages 17–23 of this document illustrate this.

Similarities and differences: IASB vs FASB

	IASB	FASB
Revenue	x	x
Operating costs (<i>excl depr and amort</i>)	---	<i>Single expense</i> ¹⁰
EBITDA	↑↑	↔
Depreciation <i>and</i> amortisation	<i>Amortisation</i>	<i>Amortisation</i> ¹¹
Operating profit	↑	↔
Finance costs	<i>Interest</i>	<i>Interest</i> ¹¹
Profit before tax	↔ ¹²	↔

The IASB lessee model will provide a richer set of information to investors than is available today, providing further insight into an entity's operations.

⁹ The FASB model is not expected to result in any material change to a lessee's income statement compared to today.

¹⁰ For existing off balance sheet leases.

¹¹ For existing on balance sheet leases.

¹² Little change expected for many lessees because of the effect of holding a portfolio of leases—see section on 'portfolio of leases'.

Individual lease

For an individual lease, the IASB model will result in a different total expense recognition pattern compared to today for existing off balance sheet leases. This is because interest expense is typically higher in the earlier years of a lease than in the later years. When combined with typically straight-line amortisation of lease assets, this results in a total expense related to a lease (interest plus amortisation) that is higher than a straight-line lease expense during the first half of the lease term. The opposite is true in the second half of the lease term. Over the lease term, the total amount of expense recognised is the same.

Portfolio of leases

Nonetheless, lessees typically hold a portfolio of leases, which generally has the effect of neutralising any effect on profit or loss compared to existing requirements. For example, if a lessee's lease portfolio is evenly distributed (ie the same number of leases start and end during a period and the lessee enters into new leases similar to those that end), then the overall effect of the IASB model on profit or loss would be neutral.

If the composition of a lessee's portfolio is not evenly distributed, then there would be an effect on profit or loss. However, a lessee's lease portfolio would usually have to change quite significantly to have any noticeable effect on profit or loss.

Because of the effect of holding a portfolio of leases, the IASB expects little change to profit or loss for many lessees.

The IASB has tested the effects of the change in lease accounting on profit or loss for a portfolio of leases. First, the IASB tested the effects of changing the lease term, the discount rate and the size of a lessee's lease portfolio, assuming that a lessee starts with an evenly distributed portfolio. The outcome of these tests indicate that total expenses related to leases change by only a small amount even when there are relatively significant changes in the overall lease portfolio (for example, when the lease portfolio grows by 10 per cent for several years or the average lease term increases from 5 years to 10 years (or vice versa)).¹³

In addition, the IASB obtained information from a software provider that set up a test portfolio of 50 real estate leases with differing lease terms and conditions, beginning and ending in different periods. The results of that test indicated that there is likely to be little effect on profit or loss from applying the IASB model for portfolios of leases. For the portfolio of 50 real estate contracts, the effect on profit or loss was estimated at approximately 1 per cent of the total expense arising from those contracts. Lease portfolio testing conducted by the FASB staff produced similar outcomes and conclusions. In addition, that portfolio testing indicated that the greater the number of leases within a lessee's lease portfolio, the more likely it is that the IASB model will have little effect on profit or loss.

¹³ See paragraphs BC451–BC465 of the Basis for Conclusions to the 2013 ED for further details.

Cash flow statement

7 Leases are financing activities

To retain the link between the balance sheet, income statement and cash flow statement, the IASB decided that a lessee would classify cash payments for: (a) the principal portion of lease liabilities within financing activities and (b) the interest portion of lease liabilities in accordance with the requirements relating to other interest paid. This is consistent with the requirements in IAS 7 *Statement of Cash Flows*.

Effects on the cash flow statement

- ↑ **Operating cash flow**
- ↓ **Financing cash flow**
- ↔ **Total cash flow**

Of course, the change in lease accounting does not cause a change in total cash flows because there is no economic change. The IASB model does, however, reduce *operating cash* outflows, with a corresponding increase in *financing cash* outflows, compared to the amounts reported today and under the FASB model.

This is because, currently, lessees present cash outflows on off balance sheet leases as operating activities whereas, under the IASB model, principal repayments on all lease liabilities will be included within financing activities. Interest can also be included within financing activities under IFRS.

The examples on pages 17–23 of this document illustrate this.

Cost and complexity for lessees: IASB vs FASB

As noted above, the Boards have decided to put the same population of leases on the balance sheet (except that the IASB allows ‘small asset’ leases to be exempt from recognition). Lease liabilities are measured on a discounted basis in a similar way under both models.

Differences arise between the models in measuring lease assets, and presenting lease expenses and cash flows in the income statement and cash flow statement.

The IASB expects the costs of applying its model to be broadly similar to those of applying the FASB model.

A lessee needs the same data to apply both models—ie (i) to identify leases (or lease components of contracts); and (ii) to determine the lease payments to be capitalised, the lease term and the discount rate of those leases.

On an ongoing basis, the IASB expects the main costs to arise from gathering that data on a timely basis so that lease assets and liabilities are recognised at each reporting date. The data required is similar to that needed to provide note disclosures for existing off balance sheet leases, with the exception of needing discount rates to apply the Boards’ new requirements.

Consequently, the IASB expects the most significant costs of applying the models to be similar for IFRS and US GAAP lessees.

Some lessees anticipate that it would be less costly to transition to the FASB model because only the balance sheet will change, not the income statement and cash flow statement. In addition, for existing off balance sheet leases, lease assets will often be measured at the same amount as lease liabilities (adjusted for direct costs, accrued or prepaid rent and lease incentives).¹⁴ Even though the FASB model (being a dual model) requires lessees to classify leases, the classification requirements are essentially the same as today.

¹⁴ Under the FASB model, differences arise between the measurement of lease assets and liabilities for existing off balance sheet leases if, for example, the lease asset is impaired.

Other lessees, however, have the opposite view. This is because the IASB model would reduce cost and complexity in the following respects:

- (a) a lessee is not required to classify leases, nor is it required to account for lease assets in two different ways;
- (b) lease assets are measured similarly to other assets. Consequently, a lessee could use existing fixed asset systems to account for lease assets; and
- (c) a lessee is not required to capitalise ‘small asset’ leases, or to prove that those leases are not material to the entity. This is expected to reduce costs, particularly for smaller entities and because entities often have high volumes of leases of low-value assets.

Extracts from comment letters to 2013 ED

One entity with a significant volume and value of leases said the following in its comment letter to the 2013 ED: *‘The introduction of two accounting models will significantly increase the implementation effort, requiring two systems to deal with the different accounting processes. We therefore strongly urge the Board to reconsider this proposal...The Type A model [in effect, the IASB model] has the advantage of being largely familiar to all constituents and should, in our view, be retained as the only model for leases other than the short-term leases.’*

Another entity said the following: *‘One of the key advantages of the 2010 ED [that proposed a single lessee model like the IASB model] over the existing lease accounting model in IAS 17 is that the requirement to classify leases between operating and finance leases was no longer present. We feel that the proposed reintroduction of a lease classification test to each lease is a step backwards.’*

2—Other effects of the IASB lessee accounting model

In response to questions raised by some stakeholders, this section describes the possible effects of the IASB lessee accounting model on (a) the cost of borrowing, (b) debt covenants and (c) regulatory capital requirements.

In considering those effects, the IASB noted the importance for the efficient functioning of the capital markets that those exposed to credit risk take on such risk on an informed basis.

Cost of borrowing

As mentioned in Section 1, the new *Leases* Standard will result in entities that currently have material off balance sheet leases reporting higher financial liabilities (and higher assets).

This is a change only to accounting. It will provide more transparent information about a lessee's existing financial commitments, but does not change those commitments. In addition, the IASB's outreach indicates that most sophisticated users of financial statements (including credit rating agencies and lenders) already estimate the effect of off balance sheet leases on leverage, particularly when an entity has a significant amount of off balance sheet leases.

Extracts from comment letters to 2013 ED

For example, in comment letters responding to the 2013 ED a bank noted the following: *'It is our understanding that most analysts and lenders (including our own lending officers) use the lease commitment disclosures that are currently required to estimate leverage and cost impacts.'*

Another bank noted the following: *'Our credit officers analyzes the credit of perspective borrowers by reviewing the notes to the financial statements to determine the amount of off balance sheet leases and the ability of the customer's current cash flow to pay for these and other items.'*

Consequently, the IASB thinks that any effect on the cost of borrowing is most likely to result from differences arising from more accurate information about lease liabilities. Lenders will be better informed about an entity's credit risk and thus will be equipped to better understand and price that risk.

It is however possible that the cost of borrowing for some entities may increase. Equally, the cost of borrowing may decrease, depending on how different the entity's recognised lease liabilities are from those previously estimated. For example, there is evidence to suggest that some common estimation techniques used to capitalise off balance sheet leases (such as annual rent expense multiplied by 8) over-estimate the lease liabilities of many entities.

Any changes to the cost of borrowing (if they occur) would result from improved decision-making based on improved transparency about a lessee's leverage.

Are differences between the IASB model and the FASB model expected to affect the cost of borrowing?

No. The recognition and measurement of lease liabilities is almost identical under the IASB and the FASB models.¹⁵ Consequently, the IASB expects investors, analysts, lenders and others to assess the lease liabilities of an entity applying IFRS in the same way as they would the lease liabilities of an entity applying US GAAP.

Some have suggested that the presentation of lease liabilities might influence how some investors or lenders view those liabilities. For example, if an entity were to present lease liabilities in more than one line item on the balance sheet (as is required under the FASB model based on the existing on and off balance sheet lease distinction), some think that this might influence whether lease liabilities are considered to be financial liabilities when assessing leverage.

Information obtained by the IASB throughout the project indicates that this is unlikely to be the case. Most investors and analysts consulted noted that they view all leases (including off balance sheet leases) as creating assets and 'debt-like' liabilities. This includes the credit rating agencies and other credit analysts consulted. Accordingly, those more sophisticated investors and analysts already seek to adjust a lessee's reported information to include off balance sheet leases when assessing leverage and the capital employed in a business. The IASB also received a similar message from lenders.

The IASB expects investors that analyse financial information without adjusting for off balance sheet leases to be among those who benefit most from the new *Leases* Standard.

The new information presented is expected to provide a better basis for decision-making by investors and analysts.

¹⁵ This is because the Boards have made the same decisions about (a) the recognition of leases on the balance sheet (with the exception of the exemption for small asset leases), (b) the definition of a lease and (c) the measurement of lease liabilities (with the exception of the reassessment of inflation-linked payments).

Credit rating methodology sample

For example, the following is an extract from Standard and Poor's corporate ratings criteria:

'We view the accounting distinction between operating and capital leases as substantially artificial. In both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments. Our lease adjustments seek to enhance comparability of reported results (both operating and financial) and financial obligations among companies whether they lease assets under leases accounted for as operating or financing leases, or use debt to finance asset acquisition. The operating-lease-adjustment model is intended to bring companies' financial ratios closer to the underlying economics and more comparable, by taking into consideration all financial obligations incurred, whether on or off the balance sheet.'

This information influenced the IASB's decision *not* to require entities to present lease liabilities in more than one line item on the balance sheet. The IASB concluded that the costs of requiring all entities to do so would be unlikely to outweigh the benefit. This is because the information obtained from most investors, analysts and other users of financial statements indicated that those users generally view all lease liabilities in the same way (ie as commitments to pay cash and, thus, as financial liabilities).

Nonetheless, if considered relevant to understanding an entity's financial position, the entity would present lease liabilities in different line items on the balance sheet in accordance with the presentation requirements in IAS 1.

Debt covenants

The changes to lease accounting could affect some debt covenants. They could also result in some entities no longer complying with debt covenants upon application of the new *Leases* Standard if those covenants are linked to an entity's IFRS financial statements (without adjustments for off balance sheet leases).

The IASB is aware from meetings with a number of banks that many debt covenants in existing financing facilities would not be directly affected by a change in accounting requirements. For example, IFRS does not define terms such as 'debt' and 'EBITDA' that are commonly used in debt covenants—accordingly, those terms are defined independently of IFRS requirements. In addition the IASB has been told that when covenants are based on amounts in financial statements, they are often based on the accounting requirements in place at the time of signing the agreements.

There is also evidence that debt covenants already take into account off balance sheet leases for a number of lessees with significant amounts of those leases.

Extracts from financial statements

For example a retailer notes the following in its financial statements: *'Debt covenants The revolver requires that we maintain a leverage ratio, defined as Adjusted Debt [adjusted to capitalise off balance sheet leases estimated as the annual rent expense multiplied by 8] to Earnings before Interest, Income Taxes, Depreciation, Amortization and Rent ("EBITDAR"), of less than four times'*.

An airline notes the following: *'...revolving credit facility... subject to the following financial covenants... EBITDAR must not be lower than two and a half times the net interest charges increased by one third of operating lease payments'* [one third is the estimated implicit interest in off balance sheet lease payments]

Because the new *Leases* Standard will provide a more faithful representation of lease commitments, the IASB would expect debt covenants negotiated after the new Standard is effective to be adjusted to reflect the change to accounting. Nonetheless, the change to lease accounting does not affect an entity's economic position or commitments to pay cash, which are often already considered by lenders. Accordingly, although the terms and conditions of future debt covenants may change, it is anticipated that those changes should be undertaken in a manner that differentiates true economic changes from accounting changes.

When setting the effective date of the new *Leases* Standard, the IASB will consider the need to allow sufficient time for debt covenants to be reconsidered.

Regulatory capital requirements

The new *Leases* Standard will result in entities that currently have material off balance sheet leases reporting higher assets and lower equity. This could affect the regulatory capital of lessees that are financial institutions.

The ultimate effect of the new accounting on regulatory capital depends on the actions of prudential regulators. As mentioned previously, the IASB has importantly concluded that a lessee should present lease assets arising from leases of property, plant and equipment as tangible assets.

In addition, the IASB has estimated the effect on reported equity of the new *Leases* Standard by considering a sample of 20 European banks. The estimated decrease in reported equity is less than 0.5 per cent of reported equity for all banks included in the sample, and less than 0.2 per cent for almost half of the sample. On the basis of this, the IASB would not expect the changes to lease accounting to have a significant effect on the regulatory capital of financial institutions.

The IASB continues to maintain an ongoing dialogue with prudential regulators and other interested parties to raise awareness of the likely effects of the new *Leases* Standard.

Appendix—Illustrative examples

This section illustrates the estimated effects of the changes proposed to lessee accounting by comparing the reported financial information under existing accounting requirements to the information that is expected to result from applying the IASB model and the FASB model.

In the illustrations, 'Today' refers to existing requirements, 'IASB' refers to the IASB model and 'FASB' refers to the FASB model.

The illustrations include some common ratios used by investors and analysts in assessing leverage and performance. Debt to EBITDA and interest cover are also the most common ratios used in debt covenants according to an academic study published in 2014—based on a sample of 8,313 deals in the US.

Retailer and Airline were selected because those are two of the industry sectors expected to be most affected by the new Leases Standard. Distributor was selected to illustrate the estimated effects on entities with material off balance sheet leases but not of such significance as those of Retailer and Airline.

Various assumptions needed to be made when preparing the estimated effects under the IASB model and the FASB model.

The main assumptions made are the following:

- (a) a discount rate of 5 per cent applies to all existing off balance sheet leases;*
- (b) under the IASB model, lease assets are amortised on a straight-line basis;*
- (c) under the FASB model, leases are classified in the same way as they are today (ie none of today's off balance sheet leases are accounted for as under the IASB model);*
- (d) small asset leases are not material; and*
- (e) the examples do not include (i) any possible difference in lease liabilities recognised under the IASB and the FASB models relating to the reassessment of inflation-linked payments; and (ii) any effects on tax.*

In addition, to provide more realistic information, estimates have been prepared on the basis that all entities hold a 'rolling' portfolio of leases. Average lease terms were estimated based on information disclosed in the financial statements.

Background information

Retailer is a food retailer with thousands of stores, both large and small. Retailer leases a large proportion of its retail space using off balance sheet leases. Those leases are predominantly longer term leases for between 15 and 30 years.

Airline reports approximately 80 per cent of its aircraft fleet on the balance sheet today (ie around 80 per cent of Airline's aircraft fleet is owned or leased under finance leases). Airline leases (under existing off balance sheet leases) approximately 20 per cent of its aircraft fleet as well as various buildings.

Distributor is a supplier of construction and building materials. Distributor leases plant and machinery, as well as real estate. Those leases are predominantly for between 2 and 10 years.

Illustration 1: Retailer

Balance sheet	Today	IASB	FASB
Property, plant and equipment	44,521	44,521	44,521
Lease assets	958	18,757	958 20,086
Other	26,703	26,703	26,703
Total non-current assets	72,182	89,981	92,268
Total current assets	38,086	38,086	38,086
Total assets	110,268	128,067	130,354
Borrowings	22,533	22,533	22,533
Lease liabilities	697	21,233	697 20,536
Other liabilities ¹⁶	57,714	57,264	57,264
Total liabilities	80,944	101,030	101,030
Equity	29,324	27,037	29,324
Total liabilities and equity	110,268	128,067	130,354
Income statement	Today	IASB	FASB
Revenue and other income	164,181	164,181	164,181
Cost of sales	(141,937)	(140,764)	(141,937)
Gross profit	22,244	23,417	22,244
Operating costs	(16,222)	(16,222)	(16,222)
Operating profit	6,022	7,195	6,022
Net finance costs	(1,293)	(2,393)	(1,293)
Profit before tax	4,729	4,802	4,729
Income tax	(1,161)	(1,161)	(1,161)
Profit for the year	3,568	3,641	3,568
Cash flow statement	Today	IASB	FASB
Operating activities	5,312	7,117	5,312
Investing activities	(3,283)	(3,283)	(3,283)
Financing activities	(2,236)	(4,041)	(2,236)
Total cash outflow	(207)	(207)	(207)

Balance sheet

- *Compared to today:* increase in lease assets and lease liabilities as explained in Section 1 of this document.
- *IASB vs FASB:* lease assets and equity higher under FASB model as explained in Section 1.

Lease assets and liabilities relating to existing on and off balance sheet leases required to be presented in separate line items under FASB model. *[Neither IASB nor FASB require presentation of lease assets and liabilities on the face of the balance sheet—amounts shown here for illustrative purposes.]*

Income statement

- *Compared to today:* no change to today's reported amounts under FASB model.
- *IASB vs FASB:* operating profit, and other profit measures before finance costs (eg gross profit), higher under IASB model because interest on all leases reported as finance costs (implicit interest on existing off balance sheet leases reported within cost of sales under FASB model).

Profit for the year different under IASB model (but only by a small amount) because Retailer holds a portfolio of leases starting and ending in different years.

Cash flow statement

- *Compared to today:* no change to today's reported amounts under FASB model.
- *IASB vs FASB:* total cash flow does not change. Cash inflows from operating activities higher under IASB model (with corresponding increase in cash outflows from financing activities) as explained in Section 1. *[In this example, Retailer reports interest within operating activities.]*

¹⁶ Other liabilities today include onerous lease provisions for off balance sheet leases that would no longer be reflected in that way.

Illustration 1: Retailer *continued...*

Common ratios

(calculated based on reported information without adjustment)

	Today	IASB	FASB
Leverage			
[A] Debt (borrowings plus lease liabilities) to EBITDA	2.4	3.5	4.5
[B] Interest cover (EBITDA to net finance costs)	7.4	5.2	7.4
Performance			
[C] ROCE (Return On Capital Employed)	11.5%	10.2%	8.2%

[EBITDA = operating profit plus depreciation and amortisation. Depreciation and amortisation is 3,601 (today and under the FASB model) and 5,334 (under the IASB model).]

[ROCE: Return=operating profit; Capital employed=equity plus borrowings plus lease liabilities]

Effects on common ratios:

Leverage

- **[A] Debt to EBITDA:** ratio of debt to earnings under IASB model (3.5 times) higher than today because debt (defined in this example as borrowings plus lease liabilities) increases by more than the increase in earnings. Ratio of debt to earnings under FASB model (4.5 times) higher than under IASB model because the earnings measure (ie EBITDA) under the FASB model includes expenses related to existing off balance sheet leases whereas EBITDA under IASB model does not.
- **[B] Interest cover:** for Retailer, under IASB model, increase in the earnings measure (ie EBITDA) is not proportionate to the increase in interest. As a result, interest cover ratio decreased to 5.2. The decrease in interest cover (and increase in interest) is substantial for Retailer because (a) expenses related to leases are large relative to the profitability of the entity and (b) Retailer has long-term off balance sheet leases.

See further explanation within Airline example on page 21 of this document.

Performance

- **[C] Return On Capital Employed:** ROCE under IASB model (10.2%) lower than today (11.5%) because the increase in operating profit is not proportionate to the increase in capital employed. The increase in capital employed under IASB and FASB models appropriately reflects that Retailer operates its business using leased assets as well as owned assets. Return on capital employed is even lower under FASB model (8.2%) because operating profit does not change compared to today, and yet reported capital employed is significantly higher than today.

See further explanation within Airline example on page 21 of this document.

The information in Illustration 1 has been prepared using reported information for a number of entities. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of the new Leases Standard on specific entities and industries could differ materially from those presented herein.

Illustration 2: Airline

Balance sheet	Today	IASB	FASB
Property, plant and equipment	27,886	27,886	27,886
Lease assets	12,030	25,430	12,030
Other ¹⁷	9,114	8,952	8,952
Total non-current assets	49,030	62,268	63,791
Total current assets	21,152	21,152	21,152
Total assets	70,182	83,420	84,943
Borrowings	9,430	9,430	9,430
Lease liabilities	10,516	25,277	10,516
Other liabilities	34,818	34,818	34,818
Total liabilities	54,764	69,525	69,525
Equity	15,418	13,895	15,418
Total liabilities and equity	70,182	83,420	84,943
Income statement	Today	IASB	FASB
Revenue and other income	67,272	67,272	67,272
Operating costs (excl depr and amort)	(60,893)	(58,340)	(60,893)
EBITDA	6,379	8,932	6,379
Depreciation and amortisation	(3,908)	(5,674)	(3,908)
Operating profit	2,471	3,258	2,471
Net finance costs	(865)	(1,656)	(865)
Profit before tax	1,606	1,602	1,606
Income tax	(285)	(285)	(285)
Profit for the year	1,321	1,317	1,321
Cash flow statement	Today	IASB	FASB
Operating activities	6,265	8,026	6,265
Investing activities	(5,190)	(5,190)	(5,190)
Financing activities	(851)	(2,612)	(851)
Total cash inflow	224	224	224

Balance sheet

- *Compared to today:* increase in lease assets and lease liabilities as explained in Section 1 of this document.
- *IASB vs FASB:* lease assets and equity higher under FASB model as explained in Section 1.

Additional information about the presentation of lease assets and liabilities within Retailer example on page 18 of this document.

Income statement

- *Compared to today:* no change to today's reported amounts under FASB model.
 - *IASB vs FASB:* EBITDA notably higher under IASB model because it does not include any expense related to leases; operating profit also higher under IASB model because it includes only a portion of expenses related to leases.
- Profit for the year only marginally different between models because Airline holds a portfolio of leases starting and ending in different years.

Cash flow statement

- *Compared to today:* no change to today's reported amounts under FASB model.
- *IASB vs FASB:* total cash flow does not change. Cash inflows from operating activities higher under IASB model (with corresponding increase in cash outflows from financing activities) as explained in Section 1. *[In this example, Airline reports interest within operating activities.]*

¹⁷ Other non-current assets today include advance off balance sheet lease payments that would no longer be reflected in that way.

Illustration 2: Airline continued...

Common ratios

(calculated based on reported information without adjustment)

	Today	IASB	FASB
Leverage			
[A] Debt (borrowings plus lease liabilities) to EBITDA	3.1	3.9	5.4
[B] Interest cover (EBITDA to net finance costs)	7.4	5.4	7.4
Performance			
[C] ROCE (Return On Capital Employed)	7.0%	6.7%	4.9%

[EBITDA = operating profit plus depreciation and amortisation]

[ROCE: Return=operating profit; Capital employed=equity plus borrowings plus lease liabilities]

Effects on common ratios:

Leverage

- **[A] Debt to EBITDA:** today, credit analysts and others typically calculate lease-adjusted leverage ratios by adjusting (i) debt (to capitalise off balance sheet leases) and also (ii) earnings (to add back off balance sheet rental expense (eg EBITDAR)). This results in a leverage ratio calculated on a basis similar to that provided by the IASB model (ie EBITDA under IASB model excludes all expenses related to leases so IASB EBITDA = Today EBITDAR and FASB EBITDAR).
- **[B] Interest cover:** the decrease in the interest cover ratio to 5.4 under IASB model is substantial for Airline because, like Retailer, expenses related to leases are large relative to profitability and Airline has long-term off balance sheet leases. This effect is comparable to obtaining a debt financed asset purchase.

Performance

- **[C] Return On Capital Employed:** ROCE substantively lower under FASB model (4.9%) because operating profit does not change but reported capital employed is significantly higher (reflecting that Airline uses both leased and owned assets to operate its business). Information from investors and analysts, and entities that prepare non-GAAP lease-adjusted information, indicates that adjustments are made to today's reported operating profit when off balance sheet leases are included as part of capital employed. Reported operating profit is often adjusted to add back estimated interest on off balance sheet leases (similar to the outcome under IASB model).

The information in Illustration 2 has been prepared using reported information for a number of entities. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of the new Leases Standard on specific entities and industries could differ materially from those presented herein.

Illustration 3: Distributor

Balance sheet	Today	IASB	FASB
Property, plant and equipment	13,745	13,745	13,745
Lease assets	116	3,167	116 3,245
Other	16,915	16,915	16,915
Total non-current assets	30,776	33,827	34,021
Total current assets	21,698	21,698	21,698
Total assets	52,474	55,525	55,719
Borrowings	12,003	12,003	12,003
Lease liabilities	106	3,351	106 3,245
Other liabilities	19,609	19,609	19,609
Total liabilities	31,718	34,963	34,963
Equity	20,756	20,562	20,756
Total liabilities and equity	52,474	55,525	55,719
Income statement	Today	IASB	FASB
Revenue and other income	55,155	55,155	55,155
Operating costs <i>(excl depr and amort)</i>	(50,973)	(49,958)	(50,973)
EBITDA	4,182	5,197	4,182
Depreciation and amortisation	(1,564)	(2,401)	(1,564)
Operating profit	2,618	2,796	2,618
Net finance costs	(824)	(1,005)	(824)
Profit before tax	1,794	1,791	1,794
Income tax	(670)	(670)	(670)
Profit for the year	1,124	1,121	1,124
Cash flow statement	Today	IASB	FASB
Operating activities	2,638	3,472	2,638
Investing activities	(1,555)	(1,555)	(1,555)
Financing activities	(915)	(1,749)	(915)
Total cash inflow	168	168	168

Balance sheet

- *Compared to today:* increase in lease assets and lease liabilities as explained in Section 1 of this document.
- *IASB vs FASB:* lease assets and equity higher under FASB model as explained in Section 1. The effect of IASB model on equity is relatively small because (a) leases are less significant to Distributor's operations than for Retailer and Airline and (b) Distributor has leases with an average lease term of approximately 8 years (considerably shorter than Retailer and Airline).

Income statement

- *Compared to today:* no change to today's reported amounts under FASB model.
- *IASB vs FASB:* EBITDA notably higher under IASB model because it does not include any expense related to leases; operating profit also higher under IASB model because it includes only a portion of expenses related to leases. Profit for the year only marginally different between models because Distributor holds a portfolio of leases starting and ending in different years.

Cash flow statement

- *Compared to today:* no change to today's reported amounts under FASB model.
- *IASB vs FASB:* total cash flow does not change. Cash inflows from operating activities higher under IASB model (with corresponding increase in cash outflows from financing activities) as explained in Section 1. *[In this example, Distributor reports interest within operating activities.]*

Illustration 3: Distributor *continued...*

Common ratios

(calculated based on reported information without adjustment)

	Today	IASB	FASB
Leverage			
[A] Debt (borrowings plus lease liabilities) to EBITDA	2.9	3.0	3.7
[B] Interest cover (EBITDA to net finance costs)	5.1	5.2	5.1
Performance			
[C] ROCE (Return On Capital Employed)	8.0%	7.8%	7.3%

[EBITDA = operating profit plus depreciation and amortisation]

[ROCE: Return=operating profit; Capital employed=equity plus borrowings plus lease liabilities]

Effects on common ratios:

Leverage

- **[A] Debt to EBITDA:** see explanation similar to Retailer and Airline examples on pages 19 and 21 of this document.
- **[B] Interest cover:** interest cover ratio only marginally different under IASB model because Distributor has leases with a shorter average lease term of approximately 8 years. This results in the implicit interest on existing off balance sheet leases being a smaller proportion of the total expense related to those leases than for Retailer and Airline, which have long-term leases.

Performance

- **[C] Return On Capital Employed:** see explanation similar to Retailer and Airline examples on pages 19 and 21 of this document.

The information in Illustration 3 has been prepared using reported information for a number of entities. It includes estimates and assumptions that could contain errors, and should be used with a degree of caution. The information has been prepared for illustrative purposes only—the actual effect of the new Leases Standard on specific entities and industries could differ materially from those presented herein.

Glossary

This glossary contains short definitions of terms used in this document.

Term	Definition
Debt covenants	Agreements between an entity and its creditors that the entity should operate within specified limits. They are agreed as a condition of borrowing.
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation.
EBITDAR	Earnings Before Interest, Tax, Depreciation, Amortisation and Rent (on existing off balance sheet leases).
FASB	US Financial Accounting Standards Board.
IASB	International Accounting Standards Board.
Lessee	An entity that leases an asset from another entity (lessor).
Non-GAAP measures	Calculations not made according to Generally Accepted Accounting Principles. There are no standardised methods for computing these measures.
Off balance sheet leases	Under existing accounting requirements, all leases other than 'on balance sheet leases'. Also called operating leases.
On balance sheet leases	Under existing accounting requirements, leases that transfer substantially all the risks and rewards incidental to ownership of the leased asset to the lessee. Also called finance leases under IFRS and capital leases under US GAAP.
Operating profit	A measure of an entity earnings from continuing operations before the deduction of interest payments and income tax. Also called EBIT (Earnings Before Interest and Tax).
ROCE	Abbreviation for Return On Capital Employed. ROCE is the ratio of operating profit to capital employed, expressed as a percentage. Capital employed equals shareholders' funds plus long-term liabilities, in other words all the long-term funds used by an entity. The ratio measures the return on all sources of finance used by an entity (ie equity plus debt) and is very similar to return on assets (which includes current liabilities). Also known as Return on Investment (ROI) or Return on Invested Capital (ROIC).

Further information

The IASB is close to finalising a new *Leases* Standard that it plans to issue before the end of 2015.

The Boards' redeliberations of the proposals in the 2013 ED have taken place in public meetings. Information about these meetings is 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>.

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