CFA Institute

LEASE ACCOUNTING SURVEY REPORT

October 2013

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ABOUT THE SURVEY

BACKGROUND AND PURPOSE

Leasing is an important source of financing for businesses. According to the White Clarke Group 2013 Global Report, the annual volume of leases amounted to US $724 billion for the year ended 2011. Despite the widespread use, the assets and liabilities arising from many leasing contracts (i.e. operating leases) cannot be found on balance sheets of the entities engaging in such financing arrangements. This accounting deficiency causes investors to make widespread guesstimates of lease obligations. A 2010 study by Credit Suisse evaluated 494 S&P 500 companies, which were obligated to make US$634 billion in total future minimum payments under operating leases. The findings of this study showed that significant variation existed between operating lease liabilities estimates based on: a) using a popular rule-of -thumb of eight times the rent, and b) discounting future lease payments using guesstimate parameters such as the incremental borrowing rate and contingent rental adjustment. The rule-of-thumb yielded an estimate of US$940 billion whereas the discounted approach yielded US$549 billion. The rule–of–thumb estimate is 71% higher than the one derived from the discounted approach. This finding shows that the full spectrum of users will be subject to measurement error, if they are restricted to making analytical adjustments based on the existing information provided through disclosures as it is unlikely that all investors will use the same inputs or valuation approach. This imperfect, but necessary, analytical adjustment by investors occurs due to incomplete and inconsistent disclosure of related operating lease information provided in the footnotes.

To address the widely acknowledged improvements needed in lease accounting, the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB) (collectively referred to as the Boards), have recently proposed the capitalization (i.e., inclusion on balance sheet) of all leases with the exception of short-term and immaterial leases. These joint Board proposals have been made through a Discussion Paper (DP) in 2009, Original Exposure Draft (Original ED) in 2010 and Revised Exposure Draft (Revised ED) issued in May 2013. These proposals by the Boards present an opportunity to enhance the transparency of lease contracts and to improve the comparability of financial statements across the globe. This joint project also provides an opportunity to further converge standards.

The purpose of this survey is to gather member views and feedback on capitalization of leasing obligations which has been one of the key projects undertaken by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) in their pursuit of seeking converged accounting standards.

The results of the survey will help inform CFA Institute’s position and allow us to best inform standard setters.

METHODOLOGY

On 2 May 2013, a global sample of CFA Institute members with an interest in Financial Statement Analysis and the financial reporting pool (10,361 total) were invited via email to participate in an online survey. One reminder was sent to non-respondents on 8 May and the survey closed on 19 May 2013. 288 valid responses were received, for a response rate of 3% and a margin of error of ± 5.8%.

EXECUTIVE SUMMARY

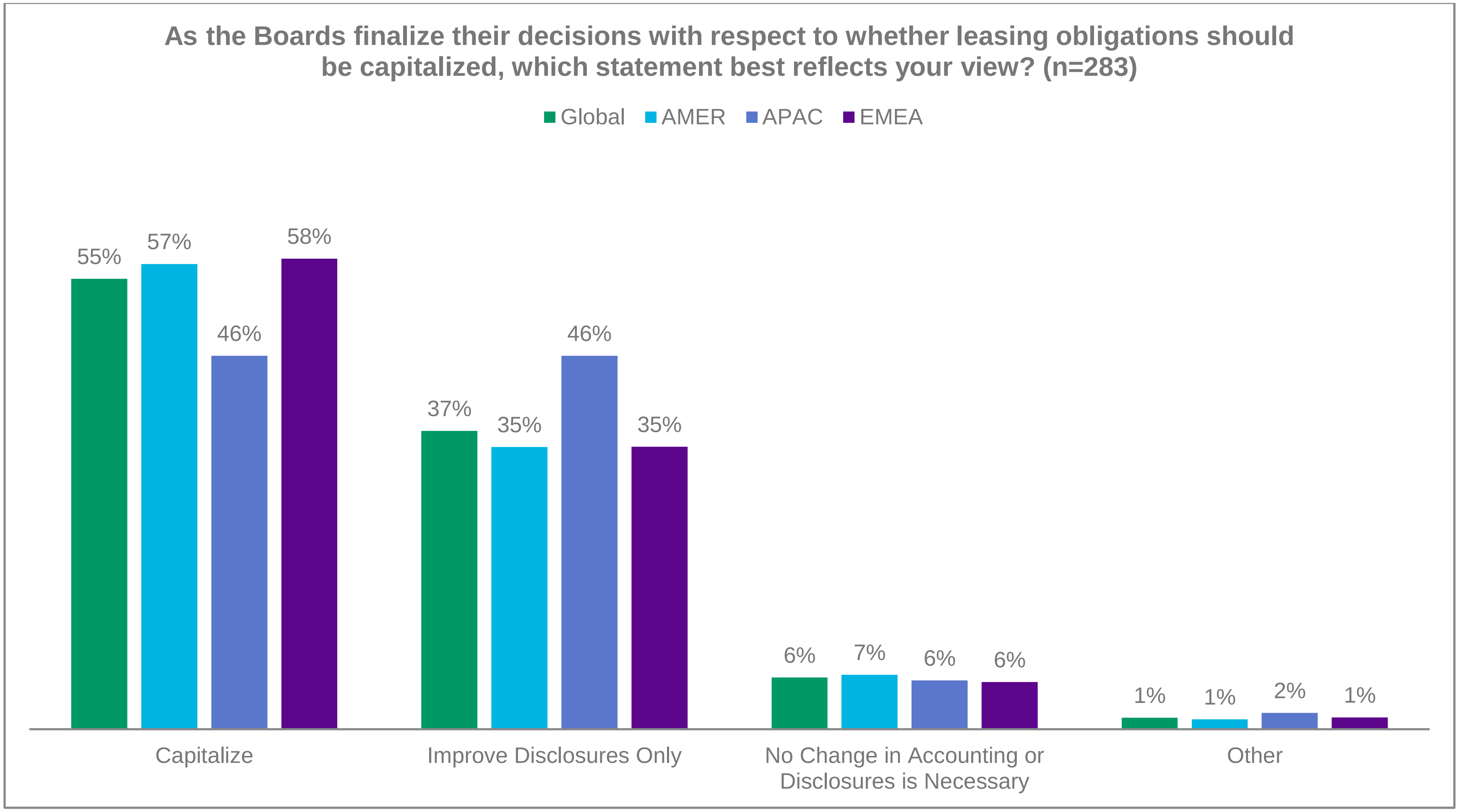
The survey findings show a majority of investors support capitalization of lease obligations and cast doubt regarding the credibility of claims of adverse economic consequences from the proposed change to lease accounting. The survey results show that most respondents also support comprehensive disclosures including those who support the capitalization of leases. These findings show that investors' requirements would be met by the Boards requiring the recognition of leases and improving disclosures. Requiring comprehensive disclosures does not negate the usefulness of capitalization of leases, which provides an improved starting point for investors' estimate of leverage. On the contrary, comprehensive disclosures will strengthen the analytical utility of the proposal to capitalize all leases.

SURVEY RESULTS

CAPITALIZING LEASES: MEMBER REQUIREMENTS

The findings from the survey related to required lease accounting changes were as follows:

- 55 percent of respondents indicate that all leases (with the exception of short-term leases) should be capitalized,
- 37 percent indicate that only disclosures need to be improved,
- 6 percent said that no change in accounting or disclosures is necessary, and
- 1 percent said other.



The survey feedback shows that capitalization is required to meaningfully enhance the transparency of lease contracts. Representative respondent comments include the following:

> *"Capitalize all leases (including short-term leases to prevent strategy of rolling-over short-term leases to create effectively long-term leases)."*
>
> *"Capitalize ALL forms of leases, including short-term leases."*
>
> *"This change is long overdue."*
>
> *"This is a great and much needed initiative."*
>
> *"All financial obligations should be reported as a liability on the balance sheet. All leases, even ones with a term less than one year, should be included on the balance sheet as a liability. We record accounts payable, why would we not record a lease payable? These off balance sheet financing arrangements have been off balance sheet for too long. If all obligations were reported on the balance sheet, you could get rid of the "other obligations" footnote. I think there may be some benefit to listing lease expenses, operating or capital, as a separate line on the income and cash flow statements as some analysts may want to separate operating costs from financing costs."*

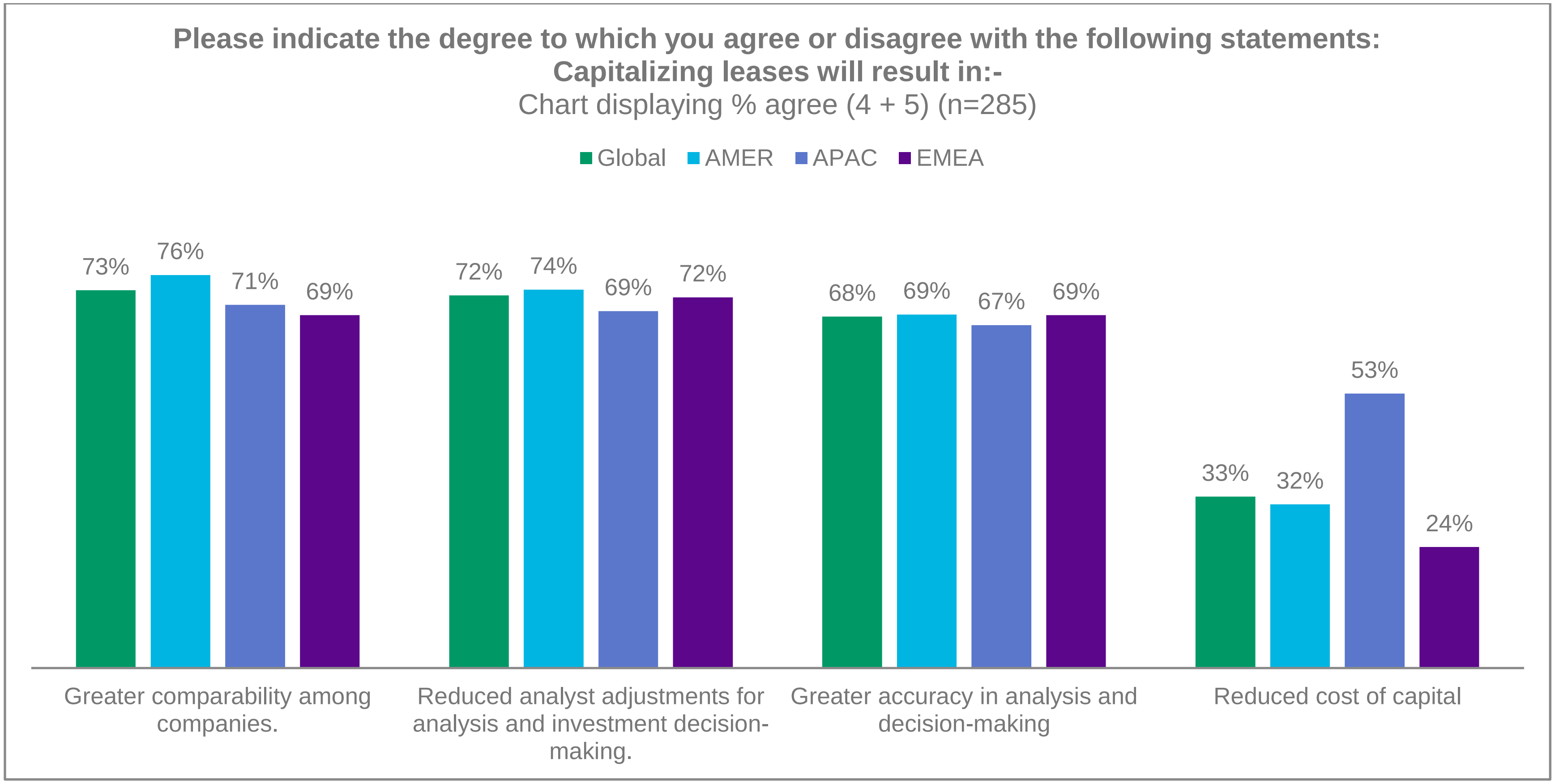
Comments from respondents show that benefits are expected from capitalization with no adverse economic consequences:

> *"Unfortunately, the IASB and FASB have been forced into the new lease standards by issuers creating lease contacts that stay just on the right side on the bright line tests to report leases as operating. It appears the solution is to capitalize everything. To properly analysis a financial statement and make it comparable, it is necessary to capitalize leases. It is sometimes hard to know if you are getting it right based on the Company's disclosure. This will be an improvement if the issuer does it properly."*
>
> *"From the perspective of a user of financial statements, leases longer than one year should be capitalized to increase transparency and facilitate communication between users and operating companies. Analysts are still free to make subjective assumptions regarding assets values and discount rates, but they will have a common basis of discussing inputs to valuation models. I find the objection to capitalizing leases on the basis of harm to the leasing industry to be questionable."*

CAPITALIZING LEASES: ANTCIPATED BENEFITS

The findings from the survey related to anticipated benefits were as follows:

- 73 percent of respondents agree that capitalizing leases will result in greater comparability among companies,
- 72 percent agree that it will result in reduced analyst adjustments for analysis and investment decision-making,
- 68 percent agree that it would result in greater accuracy in analysis and decision-making, and
- 33 percent agree that it would result in reduced cost of capital.



Scale: Strongly disagree and disagree (1 and 2) to Agree and strongly agree (4 and 5) and No opinion (3) (excluded)

The survey results reveal that investors anticipate the overall benefits to investors will outweigh any direct or indirect implementation costs. In the words of one respondent:

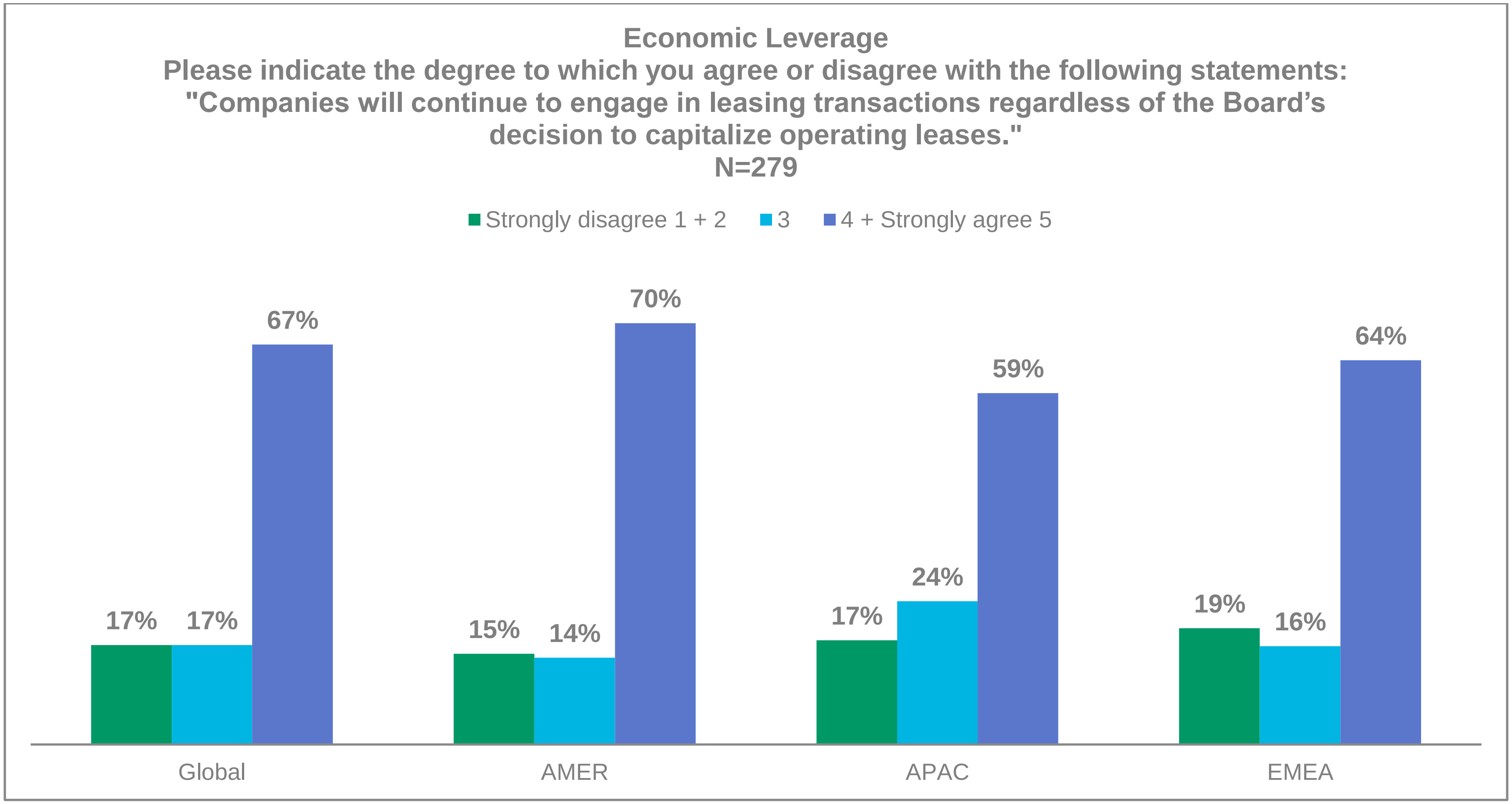
> *“This is one area where the comparability of financial statements is poor.”*

Correspondingly, the following survey respondent comment pinpoints the need for standard setters’ to act in the interest of investors.

> *“At the end of the day, for as long as corporations continue to source capital from third party institutional and retail investors, the welfare of investors should be of paramount concern of accounting standards. Standard-setters should reduce the complexity of accounting standards. Reduce the opportunities of corporations to hide things in the financial statements.”*

ECONOMIC CONSEQUENCES: IMPACT ON LEASING INDUSTRY

67 percent of respondents agree that companies will continue to engage in leasing transactions regardless of the board's decision to capitalize operating leases.



The following respondent comments casts doubt about reservations related to adverse impacts on the leasing industry:

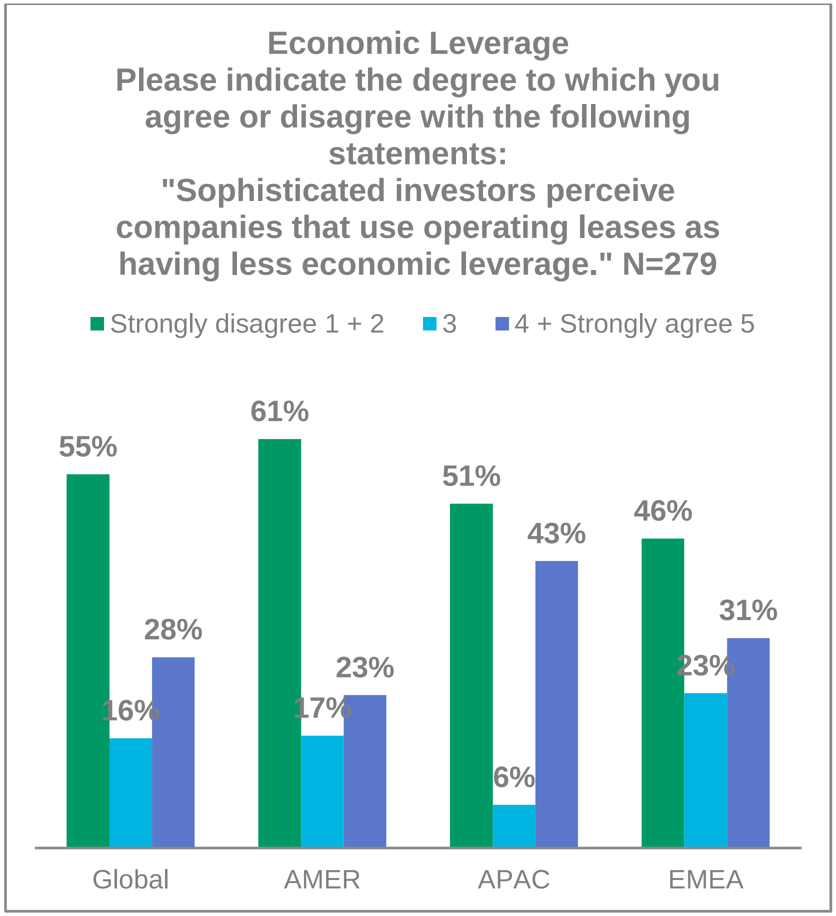
"If leases are economically relevant, then accounting standards simply requiring their capitalization will not result in the demise of the leasing industry. Those who make the argument that it will, are simply making the argument that the leasing industry exists to disguise leverage and provides no other productive economic reason for existing."

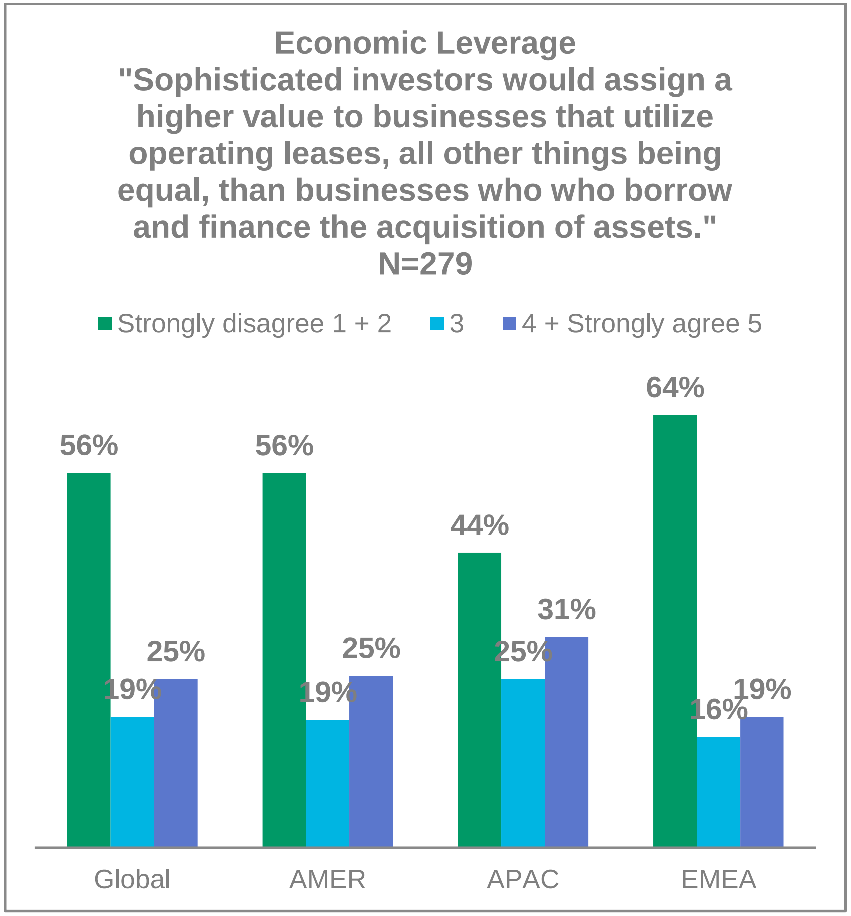
"This is a no-brainer. These are real borrowing obligations, almost all analysts capitalize them, and they reflect real leverage. I don't see why it kills the leasing business as it is predicated on favorable tax treatment more than favorable financial statement treatment. And if it does, so what, the point is to reflect reality not to bend reality because that is how it has been done. All the lease accounting tricks exist as a way to shrink the balance sheet, jack up Return on X, Y, Z type numbers etc. Just do it please – it would be a great step towards having financials actually reflect reality."

ECONOMIC CONSEQUENCES: PERCEPTION OF LEVERAGE

The survey respondents' perception of the leverage associated with operating leases was as follows:

- 55 percent (i.e. 1 and 2) disagree that sophisticated investors perceive companies that use operating leases as having less economic leverage; and
- 56 percent (i.e. 1 and 2) disagree that sophisticated investors would assign a higher value to businesses that utilize operating leases, all other things being equal, than businesses who borrow and finance the acquisition of assets.





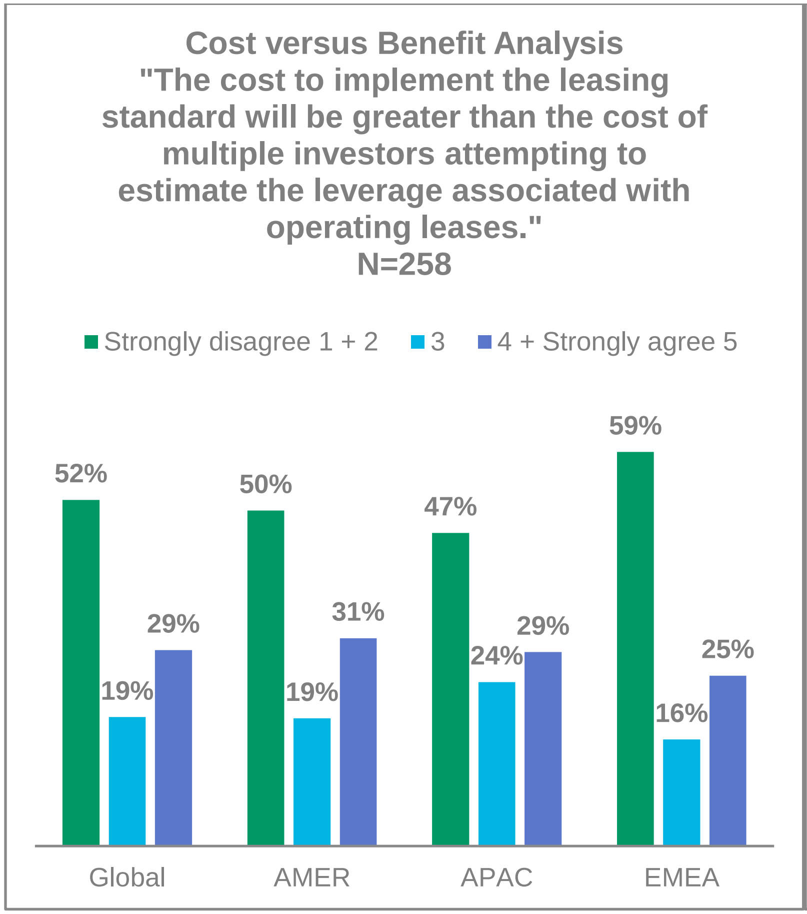
As one respondent notes:

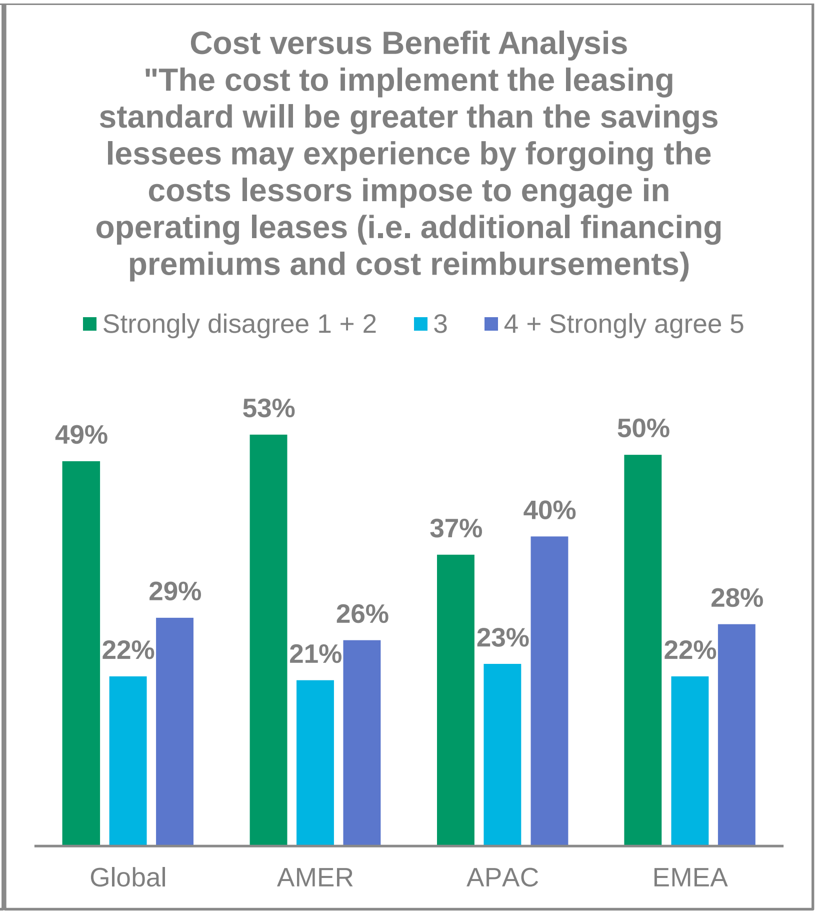
> *"An operating lease is debt….Therefore, it should be treated as debt on the balance sheet. This is similar to the old pension debate and now pension deficits are on balance sheet, as they should be."*

ECONOMIC CONSEQUENCES: COST VERSUS BENEFITS

The respondent views on cost versus benefit of the leasing standard were as follows:

- 52 percent of respondents (i.e. 1 and 2) disagree that the cost to implement the leasing standard will be greater than the cost of multiple investors attempting to estimate the leverage associated with operating leases.
- 49 percent disagree (i.e. 1 and 2) that the cost to implement the leasing standard will be greater than the savings lessees may experience by forgoing the costs lessors impose to engage in operating leases (i.e. additional financing premiums and cost reimbursements).

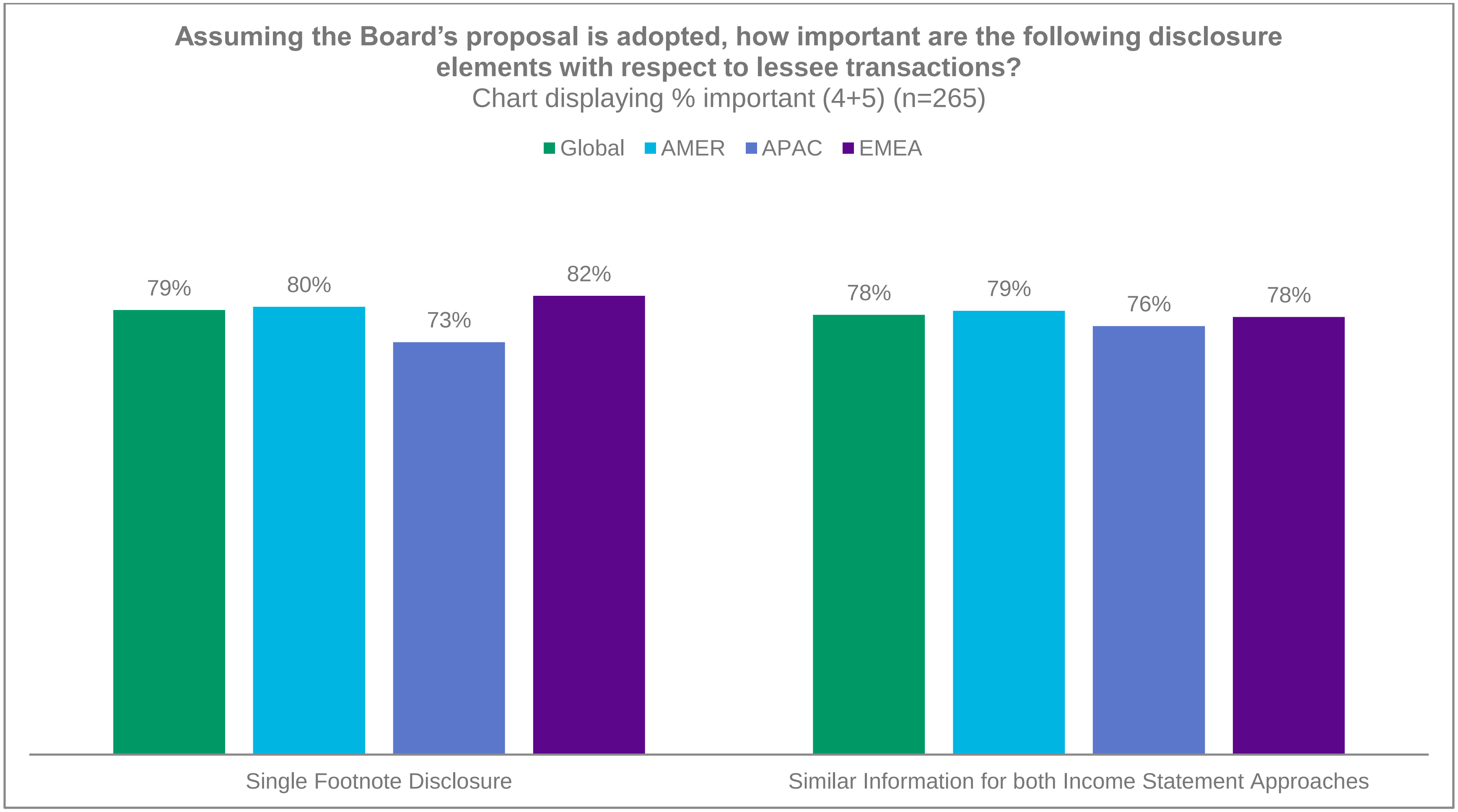




DISCLOSURES: LOCATION AND TYPE OF DISCLOSURES

The preferences of survey respondents for the location and type of disclosures are as follows:

- 79% of respondents considered single footnote disclosure to be important;
- 78% considered similar disclosure for both income statement approaches (i.e. amortization and interest expense for Type A leases and expenses for Type B leases) to be important.

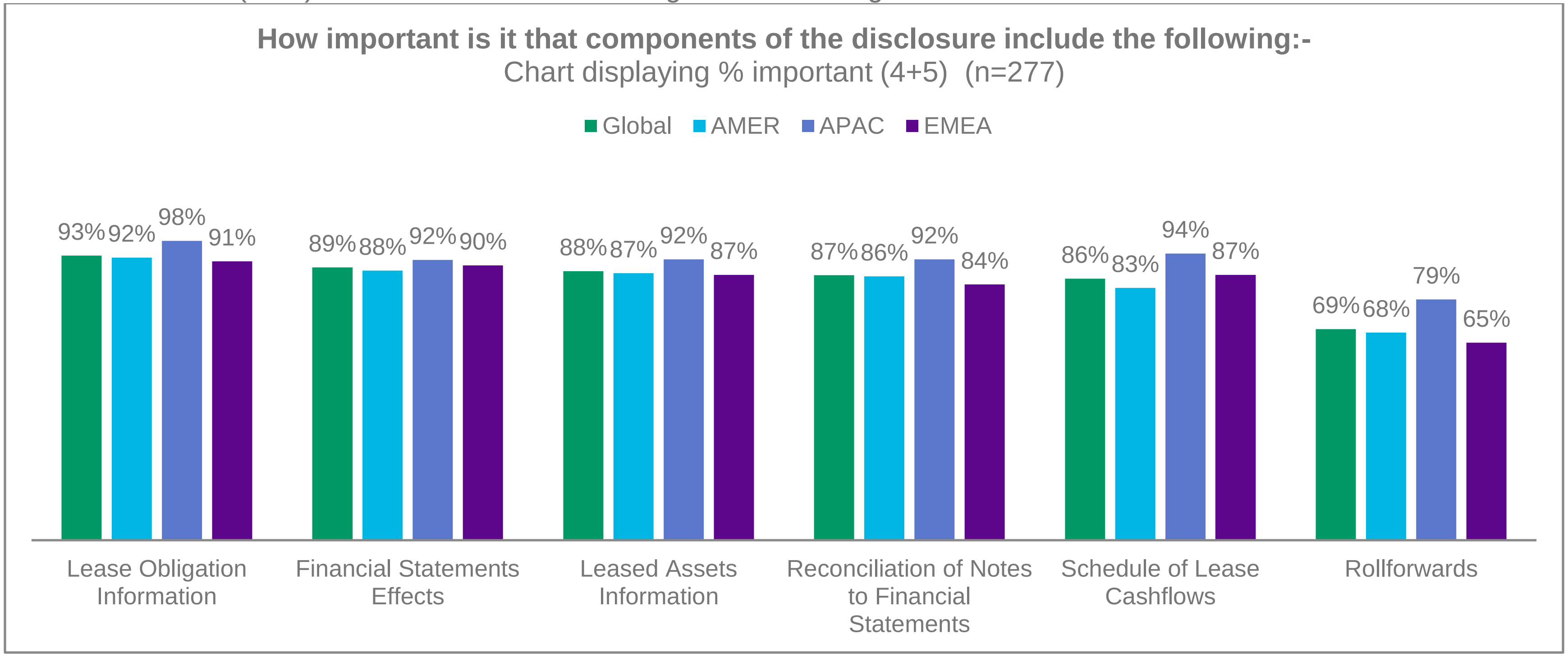


Scale: Not important at all (1) to Very important (5) and No opinion (excluded)

DISCLOSURES: SPECIFIC REQUIREMENTS

The survey results show that respondents consider disclosures of the following lease elements to be important:

- Lease Obligation Information (93%) – The nature of the lease obligation recognized including the cash flow requirements of the leasing transaction, the term of the lease, discount rates utilized in measuring the obligation and the amortization expense recognized;
- Financial Statement Effects (89%) – A summary of the effects of leasing transactions on the balance sheet, income statement and statement of cash flows;
- Leased Assets Information (88%) – The nature of the leasing asset recognized including its amortization method, period and income statement effects as well as any impairments recognized;
- Reconciliation of Notes to Financial Statements (87%) – Reconciliation of the amounts disclosed in the footnotes to the amounts recognized on the balance sheet, income statement and statement of cash flows;
- Schedule of Lease Cash Flows (86%) – A schedule of the cash flow requirements of leasing transactions, sufficiently disaggregated by maturity; and
- Roll-forwards (69%) – Roll-forward of the leasing asset and obligation.



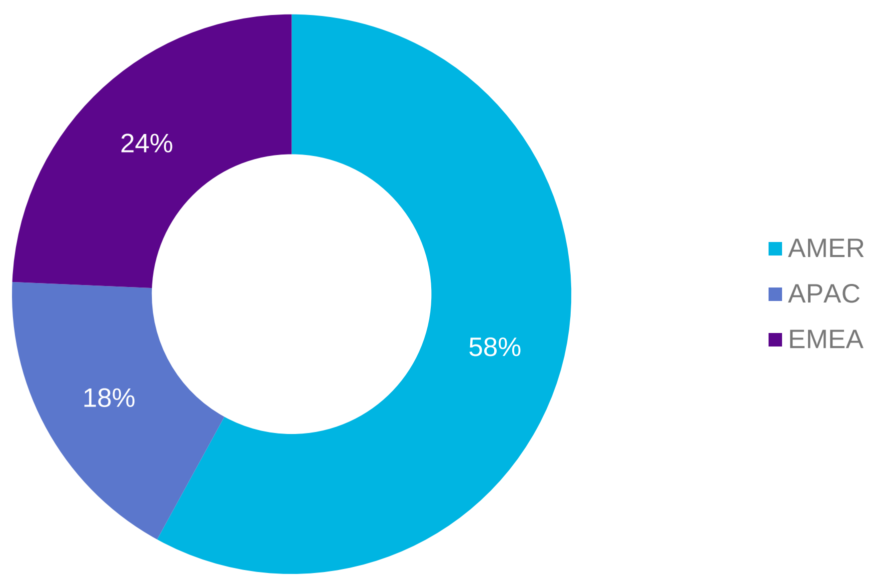
Scale: Not important at all (1) to Very important (5) and No opinion (excluded)

Several respondents provided additional comments regarding disclosures mostly surrounding the need to disclose lease terms, renewal options, percentage rents, cancellation provisions, purchase options and greater detail on maturity analysis. Below are several representative comments:

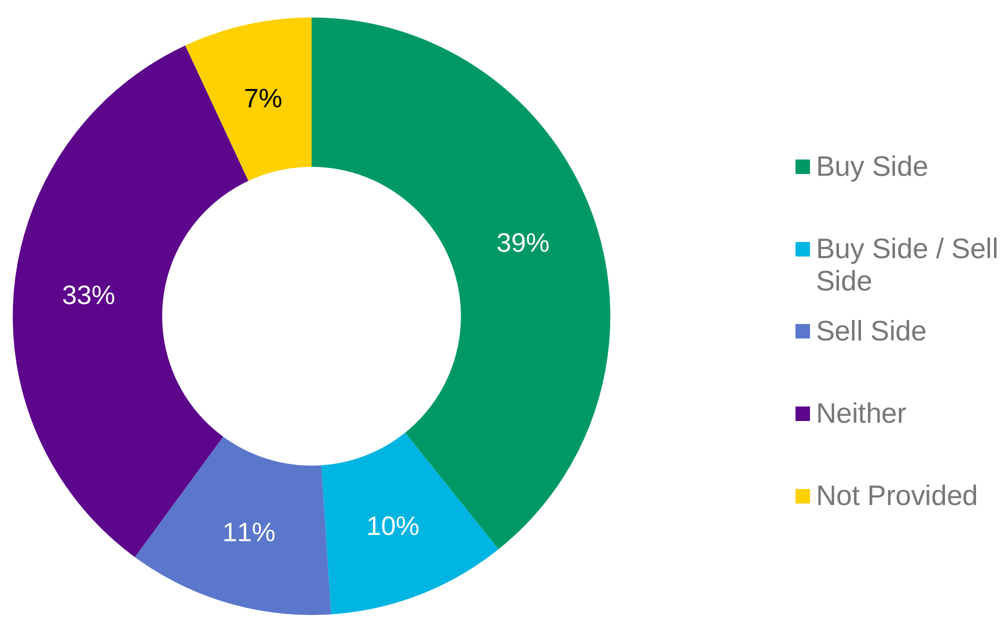
> *“Disclosure of purchase option(s) provided in the lease agreement is also important.”*
>
> *“Lease term and renewals should also be disclosed.”*
>
> *“I believe comprehensive disclosures are important. It is easy for me to disregard information about which I am not interested, so there is no harm done in providing too much detail.”*
>
> *“Each required lease payment should be disclosed, even in out years (i.e,, eliminate the lump sum for year 6 and thereafter). Lease cancellation provisions and penalties should also be fully disclosed.”*

RESPONDENT PROFILE

Region



Buy side /Sell side



SURVEY QUESTIONNAIRE

LEASE ACCOUNTING SURVEY

LEASE ACCOUNTING SURVEY

Please read the following background information to familiarize yourself with the proposal prior to responding to the survey, then click 'next' at the bottom of the page to respond to the four survey questions:

Lease accounting has been one of the key projects undertaken by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (i.e. the Boards) in their pursuit of seeking converged accounting standards. To inform our response to the Boards' Lease Accounting Project, we are seeking feedback from CFA Institute members who are users of financial statements.

The Boards issued a Discussion Paper in 2009 and an Exposure Draft in 2010. The Boards intend to issue a Revised Exposure Draft in 2013. One of the key proposals within their recent consultative documents has been the requirement for preparers of financial statements to capitalize (i.e. recognize on balance sheet) all of their leasing obligations with the exception of short-term leases (e.g. leases held for one year or less).

ARGUMENTS IN SUPPORT OF PROPOSAL
The support for capitalization is based on the following reasons:

A. Better Representation of Economic Leverage and the Economics of Lease Transactions – Leasing arrangements are being considered as equivalent to the financed ownership of assets. Capitalization of leases thereby better reflects the underlying economics of the asset and related obligation.

B. Enhanced Transparency of Leases – Capitalization is expected to provide greater transparency for investors regarding the contractual obligations emanating from leases than is provided by disclosures alone.

C. Reduced Need for Analytical Adjustments and Reduced Likelihood of Errors Associated with Analytical Estimates of Lease Related Leverage – Capitalization of all leases is expected to eliminate the need for investors to have to make analytical adjustments to quantify the obligations associated with operating leases, as tends to be the common current analytical practice. Investors currently tend to make analytical adjustments and this can be based on varied guesstimates of obligations to pay rentals.

ARGUMENTS AGAINST PROPOSAL
There has also been opposition to progressing with the project based on a variety of reasons including:

A. Expectations of Prohibitive Costs – Assertions regarding the prohibitive cost of implementing the new proposed new standard.

B. Conceptual Questions – Questions have been raised regarding the conceptual basis of all leases being capitalized given that not all leases are effective ownership arrangements. That said, through the Revised Exposure Draft, the standard-setting bodies propose to distinguish between effective ownership leases versus non-ownership leases via differences in their income statement treatment.

C. Adverse Economic Consequences to the Leasing Industry – Concerns have been voiced regarding the potential adverse economic consequences of the proposed standard. For example, potential increased capital requirements for the banking sector. Some anticipate adverse secondary effects including killing of the leasing industry, should lease financing cease to be seen as a viable option for companies.

D. Economic Representation of Measurements – The initial and subsequent measurement of the asset (i.e. right of use asset) and liability of leases (i.e. obligations to pay rentals) may yield amounts that would not represent the real economic value of the respective asset and liability.

Supporters of the leasing project have argued that the capitalization of leases is necessary to better reflect the economics of lease transactions. Some opponents to capitalizing leases have argued that the focus should be on improving disclosures of operating leases and yet other opponents go further arguing against any changes on the premise that the current lease accounting requirements are not broken and they do not need any fixing or updates.

1. As the Boards finalize their decisions with respect to whether leasing obligations should be capitalized, which statement best reflects your view?

- **Capitalize** – Capitalize all leases (with the exception of short-term leases).
- **Improve Disclosures Only** – Do not capitalize leases that are currently classified as operating leases, but improve disclosures so analysts and investors can make their own analytical adjustments.
- **No Change in Accounting or Disclosures is Necessary** – Current guidance and disclosures with respect to operating leases is sufficient.
- **Other** (please specify):
- **No opinion**

2. Please indicate the degree to which you agree or disagree with the following statements:

Capitalizing leases will result in:

	Strongly disagree 1	2	3	4	Strongly agree 5	No opinion
Reduced analyst adjustments for analysis and investment decision-making.						
Greater accuracy in analysis and decision-making, because rough estimates of leverage will be replaced by calculations based on audited balance sheet information rather than being based on estimates from notes disclosures.						
Greater comparability among companies.						
Reduced cost of capital due to decreased uncertainty faced by investors in respect of the amount and inputs used to determine the leverage of operating leases.						

Economic Leverage

	Strongly disagree 1	2	3	4	Strongly agree 5	No opinion
Sophisticated investors perceive companies that use operating leases as having less economic leverage.	○	○	○	○	○	○
Sophisticated investors would assign a higher value to businesses that utilize operating leases, all other things being equal, than businesses who borrow and finance the acquisition of assets.	○	○	○	○	○	○
Companies will continue to engage in leasing transactions regardless of the Board's decision to capitalize operating leases.	○	○	○	○	○	○

Cost versus Benefit Analysis

	Strongly disagree 1	2	3	4	Strongly agree 5	No opinion
The cost to implement the leasing standard will be greater than the savings lessees may experience by forgoing the costs lessors impose to engage in operating leases (i.e. additional financing premiums and cost reimbursements).	○	○	○	○	○	○
The cost to implement the leasing standard will be greater than the cost of multiple investors attempting to estimate the leverage associated with operating leases.	○	○	○	○	○	○

3. As noted in the background section, the Boards have proposed to recognize leases on the balance sheet as obligations – with the option of two different income statement measurement approaches. The two income statement measurement approaches are as follows:

- **Level expense recognition (i.e. similar to current operating lease expense recognition);**
- **Decreasing expense recognition (i.e. similar to finance lease expense recognition where the amortization of the asset is level and the amortization of the finance obligation decreases with the repayment of the obligation).**

Assuming the Board's proposal is adopted, how important are the following disclosure elements with respect to lessee transactions?

	Not important at all 1	2	3	4	Very important 5	No opinion
Single Footnote Disclosure – A single footnote disclosure which encapsulates all the financial statement effects of leasing transactions irrespective of the two different income statement measurement approaches.	○	○	○	○	○	○
Similar Information for both Income Statement Approaches – Similar information provided for leasing transactions irrespective of the two different income statement measurement approach chosen.	○	○	○	○	○	○

How important is it that components of the disclosure include the following:

	Not important at all 1	2	3	4	Very important 5	No opinion
Financial Statements Effects – A summary of the effects of leasing transactions on the balance sheet, income statement and statement of cash flows.	○	○	○	○	○	○
Reconciliation of Notes to Financial Statements – Reconciliation of the amounts disclosed in the footnotes to amounts recognized in balance sheet, income statement and statement of cash flows.	○	○	○	○	○	○
Leased Assets Information – The nature of the leasing asset recognized including its amortization method, period and income statement effects as well as any impairments recognized.	○	○	○	○	○	○
Lease Obligation Information – The nature of the lease obligation recognized including the cash flow requirements of the leasing transaction, the term of the lease, discount rates utilized in measuring the obligation and the amortization expense recognized.	○	○	○	○	○	○
Schedule of Lease Cashflows – A schedule of the cash flow requirements of leasing transactions, sufficiently disaggregated by maturity.	○	○	○	○	○	○
Rollforwards – Roll forward of the leasing asset and obligation.	○	○	○	○	○	○

4. If you have any additional comments, please share them with us below: