The Voice of Leasing and Automotive Rental in Europe

Mr Robert Stojek
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Re: Leaseurope's response to EFRAG's additional public consultation - Revised IASB Exposure Draft Leases

Dear Robert,

This letter sets out Leaseurope's comments on the additional public consultation on Revised IASB Exposure Draft (ED) Leases.

Identification of a lease

We remain concerned that if the IASB is to proceed with a Right of Use model, it will be very difficult for preparers to distinguish between equipment leases and in-substance service contracts. Even with the clarifications that the Boards have discussed, the line between leases and services is unclear.

Questions 1 and 2 of the consultation ask for example of transactions that would qualify as leases under the proposals, but could be in-substance services. We think the issue is more fundamental than this. It is still unclear to us how the accounting treatment of many equipment transactions would be determined.

Example 1:

Customer enters into a contract with Supplier for provision of a fleet of business cars. Customer specifies the type of car, maximum age / mileage (3 years), and required reliability and availability levels. Agreement allows Supplier to substitute cars. Around 1 car in 20 is substituted per year by Supplier. Substitution helps to achieve required service levels, as well as allowing Supplier to manage costs and optimise sales proceeds.

Under the Revised ED, it was not clear if a 5% substitution rate would be sufficient to demonstrate a substantive right to substitute assets with no barriers. It seems no clearer with the proposed clarification that tests whether the supplier would benefit from substituting an asset. The supplier would benefit because substitution is routinely taking place, but the question still arises of how much substitution is sufficient.

Under the revised ED it was fairly clear that this transaction would convey to the Customer the right to control the use of the cars, albeit with the supplier making decisions about maintenance and substitution. With the proposed clarification that now focuses right of use considerations on whether the customer decides the purpose of use of the asset, it seems slightly clearer that the Customer has control of the use.

Without clarity over whether there is a substantive right to substitute, the accounting treatment of this transaction remains unclear even with the clarifications.

Example 2:

Customer enters into a contract with Supplier for provision of print services. Customer specifies volume and quality of print output required and reliability levels. Supplier decides what equipment to use on-site at Customer's premises to meet the requirements. Supplier maintains the equipment. Around 1 in 20 printers is substituted each year to keep costs down whilst achieving contracted reliability levels.

Under IAS 17 this would probably be an operating lease. As in Example 1, both under the revised ED and with the proposed clarification, it is not clear whether a 5% substitution rate means that this is a lease or a service.

If there is an identified asset, it is also relevant here to consider the contract conveys the right for the customer to control the use of the identified asset for a period of time in exchange for consideration (paragraph 7b of Revised ED). This was unclear under the Revised ED as the customer decides what to print on each asset, but the supplier maintains. Under the proposed clarification, the key factor affecting control is that the customer determines the purpose of the use of the asset. Here the customer decides what to print, so that would suggest he does control the use of the asset.

The clarifications seem to have moved the classification towards being a lease on one hand (control of use of identified asset). However it is still unclear whether it is a lease on the other hand (whether there is an identified asset).

The characteristics of these examples are not unrepresentative of many of the larger lease arrangements for vehicles and office technology that are entered into by larger businesses. Increasingly customers are focusing more on the outputs achieved through contracts and less on the actual assets employed. In parallel, there is a strong movement towards assets being more actively managed by their owners, with equipment being moved between customers during its life, and smarter policies on timings for refurbishment, resale and recycling.

If there was a substantial saving in accounting administrative costs by classifying contracts as services (as would be the case if the current proposals were implemented) the issue of “how much substitution demonstrates a substantive right?” would become an even bigger issue for preparers, users and auditors.

In our view the ‘substitution test’ should focus on whether there is a significant reason *not* to substitute, even if for a particular contract there may not be a track record of many substitutions having already been made. It it is the existence of a substantive right to substitute that is important to the determining the accounting, rather than the actual exercise of such an option, as seen in other areas of accounting where options exist. The lessee is indeed unlikely to be well-positioned to assess the benefits to the lessor of substituting assets. The lessee is only aware of the contractual terms of the transaction.

Alternative approaches

We are unable to state a preference for either approach (Questions 3 and 4). In our view there are a number of essential requirements for a new Standard, shown in the table below. Unfortunately neither approach currently meets these or is close to doing so.

Key requirements for a new Standard	IASB Approach	FASB Approach
Clear and robust definitions of leases	No - see above	
Clear rationale for the difference between leases and services	No - see above	
Solution logical and practicable for both lessee and lessor accounting	No - very different accounting concepts would apply to lessee and lessor accounting	
Provides information that meets users’ needs	Very unclear	Slightly better than IASB approach as provides a breakdown of lease types
Avoid unnecessary and significant cost and complexity	Further significant improvements required	Better than previous FASB approach but similar to IASB overall

Conclusions

After eight years of discussions, a good solution for lease accounting still seems some distance away. In particular a better solution to lease definition is critical to achieving an IFRS that is conceptually sound and represents a coherent, robust, long-term improvement to IAS 17.

As we set out in our letter of 13 March, and we discussed on 11 June, simplifications and clarifications may appear helpful but do not address the fundamental problems with the Right of Use model, including for example the significant issues in drawing a meaningful line between leases and executory contracts.

A key requirement now is to resolve the lease definition issue, including in particular the tests that determine whether fulfilment of the contract depends on the use of an identified asset. If a robust solution to this issue cannot be found it seems to confirm that the IAS17 approach should be retained (with changes to deal with areas of particular concern about lease classifications that have arisen during the lease accounting project). IAS 17 is based on sound principles that recognise the economics of lease transactions and clearly distinguish between leases that are debt-like and those that are executory, thereby appropriately reflecting the economic positions of all parties involved in a lease transaction. The quality and logic of the distinction between Financial and Operating Leases, as stated in the principles-based IAS 17, might indeed be what is making progress on the alternative Right of Use Model so difficult.

We wish to take the opportunity also to clarify some points made recently by the IASB in relation to the new Standard. These are set out in the table below.

IASB argument	Clarification
The new standard will only affect IFRS users in Europe who are mainly large companies.	It is highly unlikely that a new standard would not, in time, be extended to cover all businesses preparing accounts in Europe, predominantly small and medium-sized enterprises, as national GAAP often follow and adapt IFRS. The new standard will most likely also have an impact in fiscal terms and even in legal terms, with new ownership issues which might arise from the proposed changes. The needs of SMEs and users of their accounts must be considered.
Investor support for the project	There is a big difference between general support for improving lease accounting and support for the current specific proposals. There is very limited evidence of investor support for the specific proposals. It should also be noted that investors have tended to express high-level views and might well have a different perspective if made fully aware of the potential burdens for the companies that they own.
Most large businesses would not be significantly affected as they do not have material use of operating leases.	Almost all large businesses are users of some operating leases, as shown in the notes to their accounts. Many are also property lessors. This would be unlikely to change.

We remain at your disposal for any further information you may require.

Yours sincerely,

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