Leaseurope

The Voice of Leasing and Automotive Rental in Europe

IFRS Lease Accounting – the 2013 ED

What European stakeholders really think about the IASB's Lease Accounting Proposals

I. Objective of this document

This brief document provides insight into the views of the most important European stakeholder groups in the context of ongoing the review of IFRS lease accounting. While it is not intended to be an exhaustive analysis of the more than 600 comment letters submitted to the IASB and FASB on their 2013 Exposure Draft "Leases", which is the third round of public consultation on this project, it makes reference to the official positions of these stakeholders. The document can be used as a starting point to better understand whether and to what extent the proposed changes to lease accounting would be useful or appropriate in a European context.

II. Auditor views

The auditor community has largely rejected the 2013 ED proposals. Four of the five main audit firms, i.e. **Grant Thornton, KPMG, Deloitte and Ernst & Young, are not in favour of the proposals**[1]. The reasons for this include:

- No increase in the relevance of information for users of accounts in comparison to the high implementation costs for preparers
- Complexity of the proposals and unjustifiably high implement costs for preparers of accounts
- No conceptual basis for key aspects of the proposals (such as the definition of a lease compared to a service contract, the measurement proposals for lessees, the proposed models for lessors and their interactions with the lessee proposals, etc.).

The following extracts from the auditors' official comment letters on the ED clearly illustrate their lack of support for the ED proposals and also highlight some of the major issues they consider have not yet been dealt with by the Boards:

[1] We note that although PwC expresses broad support for the model, they also have reservations with the proposals, notably on the classification criteria used to distinguish between Type A and Type B leases and suggest retaining IAS17 criteria as the basis for this split.

"We believe the latest proposals would not improve financial reporting and would require substantial implementation costs. (…) moving forward with a right of use model is supportable only if a lease can be defined in a manner that satisfactorily distinguishes leases from executory contracts (service contracts). We believe the ED's proposals and supporting examples fail to achieve this – quite possibly because in many instances such a distinction does not exist." **Grant Thornton** (Comment Letter 117*)*

"We continue to support the Boards' objective to develop a single less complex approach to lease accounting and the broad principle that assets and liabilities arising under leases should be recognised in a lessee's statement of financial position. However, the Boards' work on this project to date has not produced a broadly consistent view among their constituents about what a lease represents, or how it should be reported in the financial statements." **KPMG** (Comment letter 199)

"We (…) believe there are questions about whether the cost-benefit analysis of introducing this new model continues to support the case for change at this stage of the development of the ROU concept." **Deloitte** (Comment letter 262)

"We are unable to support the Proposal because it is unclear to us whether the ED would significantly improve the decision-useful information available to financial statement users. It also is unclear to us whether any of the perceived benefits to financial statement users would justify the costs and complexity of applying the ED." **Ernst&Young** (Comment letter 297)

Suggestions from these audit firms to move the project forward are to retain the existing accounting model with improved disclosures and, drawing on what has already been learnt, develop a more conceptually sound model that would pass a cost/benefit test.

Moreover, the **European audit profession**, as represented by the **Federation of European Accountants (FEE),** has also rejected the proposals as they stand, saying the following in their comment letter:

"Despite the improvements noted above, we do not support the ED on conceptual and practical grounds. (…) we believe that the proposals in the ED are overly complex and not robust conceptually." **FEE** (Comment letter 86)

The **Association of Chartered Certified Accountants (ACCA)** explicitly calls for the Boards to abandon the right of use concept:

"Following extensive project work and consultations over several years, the IASB is again proposing a Right of Use (RoU) model for leasing. ACCA finds that it still cannot support a RoU model, including in the revised form proposed in the current ED. Consequently, we believe that the IASB should now abandon attempts to incorporate RoU methodology in a new Standard on leasing." **ACCA** (Comment letter 308)

III. Preparer views

Given that most European businesses may be considered to be lessees and/or lessors under the proposals, a vast number of European preparers have submitted views to the Boards. Their commentary focusses on the unnecessary complexity and costs of the proposals, as well as on the theme of the lack of conceptual robustness of the model. As such, it does not appear to be reasonable to conclude that European preparers are supportive of the proposals.

It is useful to look at the comment letter of **BusinessEurope**, an organisation representing all sizes of European firms through its national business association members, to get a representative overview of European preparer views. Indeed, this cross-section of European business views is that the **proposals are not acceptable**.

BusinessEurope's submission to the IASB states that:

"BusinessEurope considers that the current ED does not meet the goal of a high quality standard and consequentially cannot accept the proposals as they stand. Most members accept the existence of two types of leases, but consider that the split between these should not be based on the nature of the underlying asset and think that different presentation and measurement options should be considered for the two types of leases, with only one type recognised in the balance sheet. Other members desire a single simple treatment for all leases. Overall we would support enhancing IAS17 disclosures rather than implement the proposed model." **BusinessEurope** (Comment letter 599)

In order to give the reader further insight into the views of European preparers in a variety of economic sectors, we have provided extracts from the responses of a number major European corporates, all featuring in the **Financial Time's 2013 FT Europe Top 500**. These brief extracts have been select so as to reflect the respondent's overall position on the proposed changes as best as possible.

"The ED creates accounting and financial reporting requirements that are not consistent with the IFRS conceptual framework. This is a real concern to us as we consider that this undermines the future work of the Board in other areas. (…) For that reason we strongly urge the Board not to implement the ED as it stands today and to undertake a revision of the draft based on a definition that captures better the type of transactions that the Board would like to see on balance-sheet." **Sanofi**, **#8 of the FT Europe 500** (Comment letter 600)

"(…, Siemens has undertaken a detailed analysis of the boards' new proposals and has come to the conclusion that even after these changes to ED 2010 it is more than questionable for us if the Re-ED will result in a reasonable cost-benefit relation. From our view, in many cases the boards' proposal will lead to economically similar transactions being accounted for in a considerably different way. (…) We, therefore, suggest that the IASB reconsider the alternative approach to recur to IAS 17 for the basic concept of lease accounting and to address its key concerns by redefining disclosure requirements. (...) In addition, this approach would be more cost-beneficial than the proposed requirements and would still achieve most of the objectives of the leases project. In fact, for many financial statement preparers, including Siemens, lease arrangements as lessee are mainly used in combination with certain services offered by the lessor in a package and not as a source of external financing." **Siemens, #17 of the FT Europe 500** (Comment letter 194)

"The ED fails the original goal of the IASB to reduce complexity and to increase comparability in lease accounting. (…) we generally believe that existing IAS 17 provides well known information for users of financial statements and is generally accepted by lessors as well as by lessees. As a consequence the IASB should cancel the whole leasing project and retain current IAS 17. Alternatively it would be possible to expand the current notes in IAS 17." **Volkswagen, #18 of the FT Europe 500** (Comment letter 303)

"Why doesn't the Board fine-tune the principles and definitions of IAS 17 to efficiently prevent unfaithful implementation? (…) A standard relying on flawed concepts is far more problematic than a poorly applied standard. If the objective was to obtain the value of a theoretical liability, then why not enrich the footnotes as proposed in the ED to provide users with all information they need?" **LVMH, # 19 of the FT Europe 500** (Comment letter 506)

"We continue to maintain very serious concerns about the IASB's Lease proposal. (…) We strongly believe that the Lease project (i) runs counter to the natural understanding of the business, at least in the case of the retail business, (ii) renders the preparation of financial statements more complex and expensive, (iii) will result in a lack of reliability and comparability in information for users and (iv) breaks many fundamental principles of current IFRS." **Inditex, #22 of the FT Europe 500** (Comment letter 488)

"In summary, we do not believe that the proposals represent a significant and conceptually sound improvement over the current lease accounting model. Also, in our view, the current practice works well and is understood by preparers and users. (…) For these reasons, we support that in the short term, as a first step, the Board should bring improvement to the existing limitations with certain limited amendments to IAS 17 and relevant disclosures that provide users with information on minimum commitments and maximum potential future cash flows disaggregated by category of underlying asset. The Board should then revisit its decision to replace the existing lease model and eventually focus on building conceptually sound accounting requirements for lease transactions." **Telefonica, #37 of the FT Europe 500** (Comment letter 511)

"Overall, we do not see an obvious improvement comparing the ED with IAS17 which would justify the spending tremendous one-time and on-going costs and efforts and to potentially generate significant economic impact on the well-established leasing business. Rather, we would suggest enhancing the existing IAS17 by additional disclosures instead of introducing a new lease accounting standard." **Daimler, #39 of the FT Europe 500** (Comment letter 593)

"Under the proposals, all lease arrangements will give rise to a lease liability and a right-of-use asset, irrespective of their nature. We believe that for many lease arrangements, the existence of these liabilities and right-of-use assets does not satisfy the conceptual framework. (…) We recommend that properties leases are not recognised on the balance sheet and that lease payments are recognised in the Income Statement on a straight line basis. Furthermore, the proposed disclosure requirements should be rationalised and improved." **Tesco, #50 of the FT Europe 500** (Comment letter 513)

"We are convinced that IAS17, if properly applied, minimizes opportunities to "structure" transactions. Indeed, we think that the risks and rewards (returns) analysis is the best way to prevent from "structuring" contracts because it measures the economics of transactions and is used by the committees entitling investments. (…) The RED (re-exposure draft) model is very complex, accounting is not consistent between lessee and lessor and we feel that the definitions of service/lease contracts and purchase/sale/leases are not elaborated on an economic substance basis." **GDF Suez, #51 of the FT Europe 500** (Comment letter 547)

"(..) the concepts of the guidance proposed in the latest ED raise a number of concerns which we highlight in this Comment Letter. As you know, the proposed accounting will result in enormous additional cost and has a massive IT and process impact (our initial estimate is a three digit million Euro amount in Germany alone). Many issues and serious concerns arise as a consequence. (…) The leasing project is very controversial, in our opinion, largely because of the Boards' approach to completely change the classification tests, expense recognition, balance sheet classification and cash flow statement presentation for lessees. Another reason for controversy is that the proposed rules are complex and in many cases will not reflect the economic effects of leases as well as the current rules do. At the same time, leases are used by virtually all companies and everybody is affected. "**Deutsche Telekom, #53 of the FT Europe 500** (Comment letter 164)

"(…) we are not convinced that the proposals in the ED will result in a sufficient enhancement of the usefulness of financial information for users of the financial statements to justify the considerable cost and complexity of implementation. The implementation of the ED will result in significant incremental costs for companies, including the costs of extensive data gathering and data analysis, development of management information systems, changes to underlying business processes and controls, and the education of internal and external stakeholders. We are also concerned about the high-maintenance nature of the proposals on an ongoing monitoring basis." **BT Group, #81 of the FT Europe 500** (Comment letter 537)

"With respect to the general approach chosen for changing lease accounting, we still have serious concerns with the proposed right-of-use concept and share the concerns raised by EFRAG in their Draft Comment Letter dated July 8, 2013 that such a concept has never been debated on a conceptual level. We are not convinced that the distinction between lease contracts and service contracts in BC20-23 is conclusive and final. We still have concerns why a lease contract leads to right-of-use assets while in other contracts where both parties have partially performed their obligations to an equal extent (executory contracts as defined in IAS 37) this is not the case. We still miss a thorough conceptual analysis of other types of executory contracts with respect to potentially resulting rights-of-use assets and related obligations coming out of these contracts. We therefore support EFRAG's recommendation not to change IAS 17 but to bring improvement to the existing limitations with relevant disclosure of leases." **Deutsche Post DHL, #95 of the FT Europe 500** (Comment letter 476)

IV. EFRAG's views

EFRAG, the **European Financial Reporting Advisory Group**, is the body that advises the European Commission on the adoption of IFRS into EU legislation. An essential part of its role is to provide the IASB with the European perspective on any new IFRS standards being developed. In a European context, EFRAG is therefore one of the most important commentators on and contributors to the IASB's work.

EFRAG's feedback on the 2013 Exposure Draft is fairly critical. Their comment letter (Comment letter 618) recalls the fact that EFRAG has repeatedly insisted on the need to refine right of use approach conceptually. It also draws attention to the heavy costs the proposals would generate, saying that the proposals are "far from reaching an appropriate cost/benefit trade off".

Given their concerns on both the conceptual consistency as well as on the cost and complexity of the ED, they conclude that "**the current proposals will not lead to improvements in financial reporting**" and recommend that **the IASB does not finalise the Standard on the basis of the ED**.

V. User views

According to the **IASB staff feedback summary**, the majority of users support the **recognition of lease assets and liabilities**.

However, this summary statement does not necessarily mean that users support the main thrust of the ED proposals. Indeed, as pointed out by feedback from the auditor community (see above), it is not the recognition of assets and liabilities per se that is the issue at stake, but rather what users think a lease is and in which circumstances they consider that such contracts give rise to assets and liabilities.

Obtaining input from the user community on the lease project has been an ongoing challenge for the IASB. In order to improve on this situation, the IASB conducted 45 individual outreach meetings with various users to better understand their views on the 2013 ED. While the IASB's efforts are commendable, their overall summary of user views is mainly based on the staff's accounts of these private meetings and not public consultation. Only 20 or so of the more than 600 comment letters submitted to the Boards are from user representatives. Given the nature of this outreach, as well as the very broad range of contracts with differing economic effects that can be referred to as leases, it is unlikely that sufficient understanding of users' views on definition of a lease (and hence the scope of the proposals and the identification of situations when assets and liabilities effectively arise) has been achieved.

The IASB staff also notes that there is more divergence in the views of equity than credit analysts, showing that there is not an equal level of support amongst different types of analysts and that different users have different informational needs. It is likely that even greater divergence in views would be found if the needs of analysts were taken into account depending on their sector specialisation, etc.

EFRAG also took part in European user outreach and confirms the diversity of their opinions in their summary of the message received:

> *"EFRAG received very diverse messages (from users). The majority of participants supported recognition of lease assets and liabilities and presenting them on the face of balance sheet. However, only a few of them supported the Type-A and Type-B split. Some of them would also prefer the whole asset approach instead of the right-of-use model. Some participants disagreed with the proposals and suggested that improvement of disclosure package in IAS 17 will be much more useful."* **EFRAG**, **Summary of Feedback from Users Outreach Events**