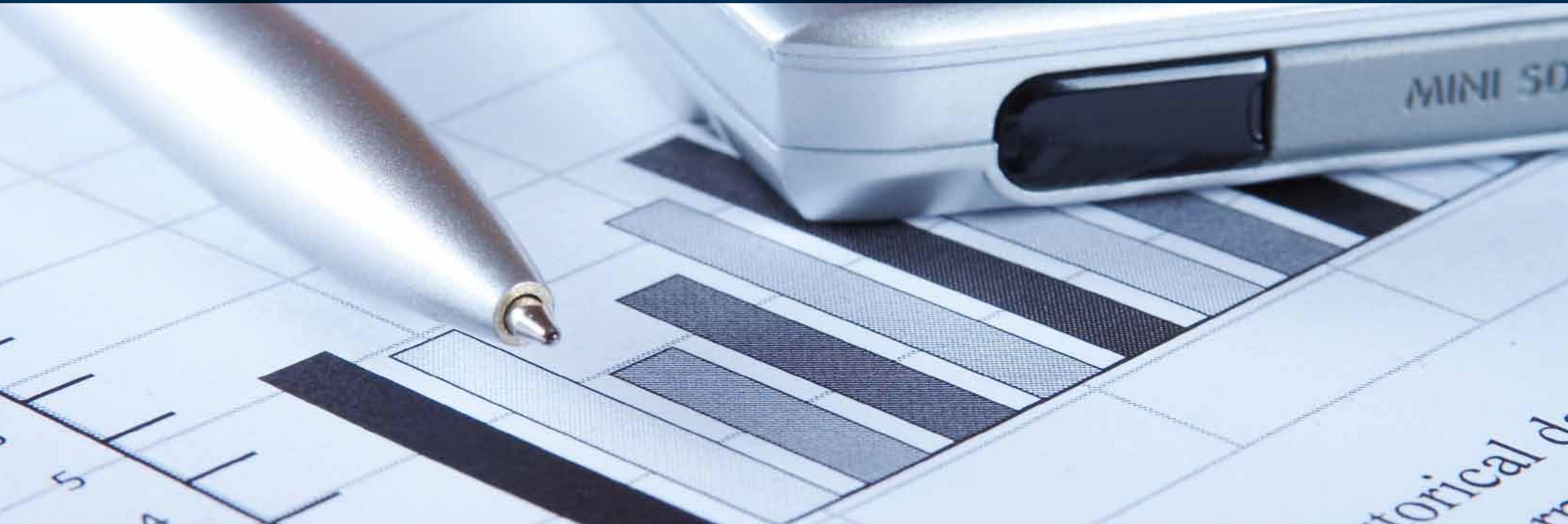
NEW EDITION
2012

# European Leasing

A Joint Leaseurope and KPMG 's Asset Finance Tax Network Publication



# Acknowledgements

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- Our Member Associations for contributing their figures and providing overviews of recent developments in their markets.

- KPMG's Asset Finance Tax Network and especially, Seamus Hand, Chairman of KPMG's Asset Finance Tax Network (KPMG in Ireland), and Wolfgang Griesbach, Head of Asset Finance Tax (KPMG in Germany).

- Andrea Wesolowski, Leaseurope's Knowledge and Membership Management Adviser, and Sonia Galley, KPMG's Global Practice Manager in Financial Services Tax, for coordinating the project.

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# Index

Introduction

# Introduction

Welcome to the second edition of the joint Leaseurope and KPMG's Asset Finance Tax Network publication on the European leasing industry. The publication reviews, in a comparable format, the state of the leasing markets in 32 European countries as well as the different legal, accounting and taxation frameworks for each of these countries' leasing industries.

There has always been a strong demand for a comprehensive, easy-to-use reference tool on leasing in Europe, which is why Leaseurope, the trade association representing the European leasing and automotive rental industry, and KPMG 's Asset Finance Tax Network, with their highly respected and knowledgeable international network of specialists on leasing taxation, came together in 2007 to produce a synopsis covering leasing market data and the regulatory aspects of leasing throughout Europe. As a result of the original publication's enormous success within the industry, Leaseurope and KPMG's Asset Finance Tax Network decided to work together once again.

This updated publication works exactly as it did in the first edition. Each national leasing market chapter contains two sections. The first section, provided by Leaseurope, reviews the size and growth of the market, along with details on the types of leased assets in the country and other lease contract characteristics. Unless otherwise specified, this information is presented in such a way so as to render it comparable from country to country and is based on data collected from Leaseurope's Member Associations within the context of the federation's 2010 Annual Statistical Enquiry and 2011 Biannual Statistical Enquiry (which reflect the situation of Leaseurope's Member Association at 31 December 2010 and 30 June 2011, respectively). These enquiries contain the most recent and extensive information available for the European leasing market at time of publication.

The second part of each country chapter contains a description of the regulatory, fiscal and accounting background of the local leasing market. This information has been provided by members of the KPMG's Asset Finance Tax Network who have leveraged their knowledge of national leasing legislations, direct and indirect taxation regimes as well as local accounting standards to provide a full overview of the regulatory environment in which the local leasing industry evolves. The information provided by KPMG's Asset Finance Tax Network reflects local situations at end 1 March 2012, unless stated otherwise within a country chapter.

Furthermore, in order to provide a general overview of the European leasing market, overall European leasing statistics are presented at the beginning of the publication, in the same format as the individual country chapters. The preliminary European chapter also contains a glossary of the terms used in the various market descriptions. This is followed by an outline of the international accounting standard for leasing, IAS17, the application of which has been mandatory on a consolidated basis for all listed companies in the EU since the beginning of January 2005.

We hope that you will find this compilation on European leasing interesting and useful. More information on European leasing and the activities of Leaseurope can be found at www.leaseurope.org. Local KPMG's Asset Finance Tax Network contact details are located within each country chapter.

# 01
# European Leasing Market

# European Leasing Market
2010

## Federation Profile

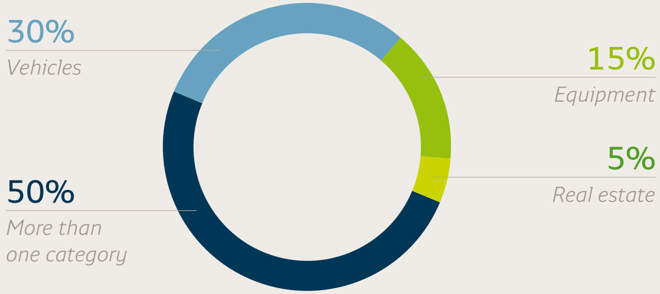
Leaseurope

The Voice of Leasing and Automotive Rental in Europe

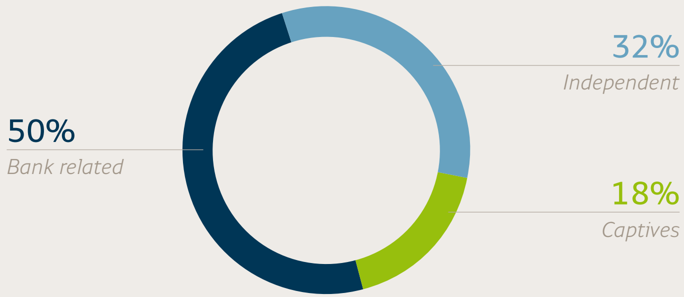
www.leaseurope.org

- Total number of member associations *(end 2010)*: 46
- Total number of individual leasing companies in Europe reported in the 2010 Leaseurope Annual Enquiry: 1 303
- Leaseurope represents on average 93 % of the European leasing industry in terms of new leasing volumes
- Profile of European leasing firms:

*Percentage of European leasing companies active in leasing the following types of assets*




*Percentage of European leasing companies according to shareholder type*



# European Leasing Market[1]

## 2010

| New leasing volumes | Outstandings |
|---|---|
| € 223 954 Mil | € 674 226 Mil |

## H1 2011

| New leasing volumes | Outstandings |
|---|---|
| € 115 117 Mil | € 630 829 Mil |

## New volumes total growth[2]

| 2009 / 2010 | H1 2010 / H1 2011 |
|---|---|
| + 4,6 % | + 10,10 % |

## European leasing penetration rate[3]

2010
12,6 %

# → Equipment and Automotive Leasing

## Total new equipment and automotive leasing volumes

| 2010 | H1 2011 |
|---|---|
| € 194 424 Mil | € 102 971 Mil |

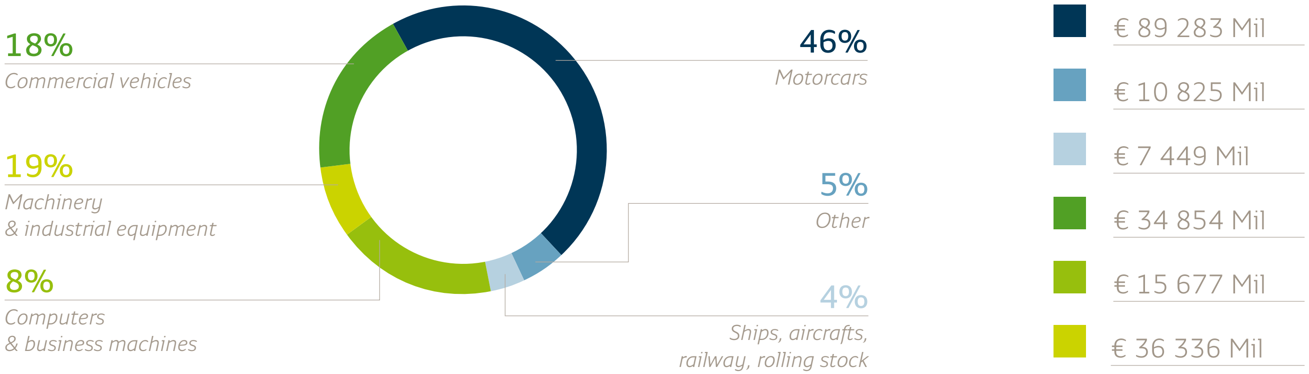
## New volumes total growth

| 2009 / 2010 | H1 2010 / H1 2011 |
|---|---|
| + 3,1 % | + 11,15 % |

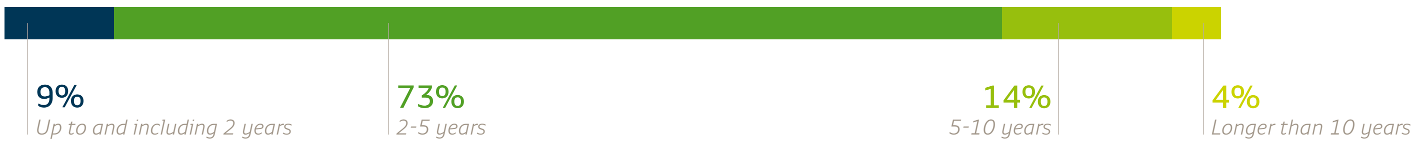
1. The following figures are those of the 31 leasing and long term automotive rental members that took part in Leaseurope's 2010 Annual Enquiries and the 26 leasing and long term automotive rental members that took part in Leaseurope's 2011 Biannual Enquiries.
2. Calculated based on a constant sample of members reporting in Leaseurope's various Annual and Biannual Enquiries.
3. The penetration rate shows the amount of investment in a given country financed by leasing and is calculated as total new volumes reported in the Leaseurope Annual Statistical Enquiry divided by total investment (excluding dwellings). Investment is defined as Gross Fixed Capital Formation minus investment by private persons in dwellings (i.e. excluding residential real estate). Investment figures are taken from Eurostat.

## Share of new leasing volumes in 2010

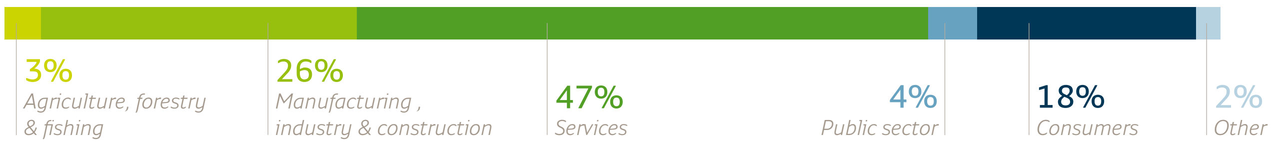
### By asset type



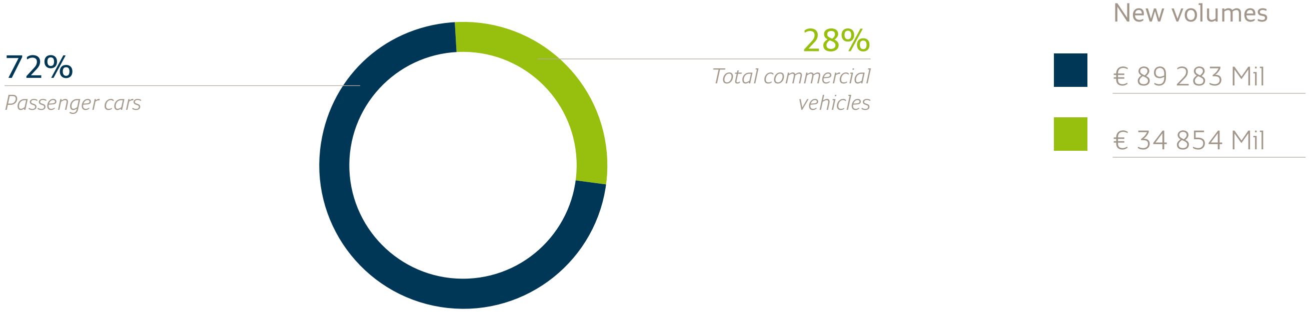

### By contract term




### By client type




## New automotive leasing volumes by vehicle type



# Real Estate Leasing

## Total new real estate leasing volumes

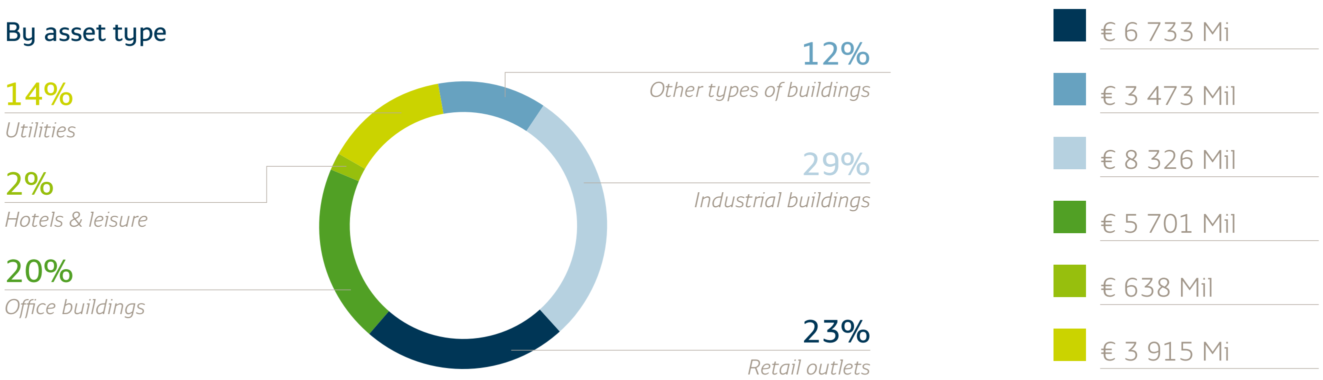
| 2010 | H1 2011 |
|---|---|
| € 29 529 Mil | € 12 147 Mil |

## New volumes total growth

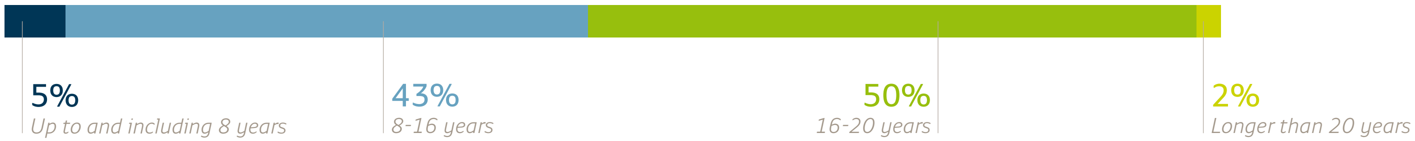
| 2009 / 2010 | H1 2010 / H1 2011 |
|---|---|
| + 15,3 % | + 1,94 % |

## Share of new leasing volumes in 2010

### By asset type




### By contract term



# European Leasing

Leasing is a special form of asset-based financing where a leasing company makes an asset it owns available to another party for a certain period of time, in exchange for payment. It is used to finance an extremely wide range of asset types providing a valuable form of support for a broad scope of businesses, whatever their asset needs may be. Leased assets can include a variety of different products, such as: cars, trucks, plant and machinery, yellow goods, planes, ships, real estate, ITC, equipment, renewable energy equipment, healthcare equipment, printing equipment, forklifts, production plants, office furniture, cranes, software applications and many more.

Additionally, lease agreements can be distributed via many channels, e.g. through bank networks, directly from leasing companies or through vendors and dealers of equipment. The most popular means of accessing leasing is at the point of sale of the asset, or the vendor channel. This is when the customer accesses the lease directly from the manufacturer at the point of sale, saving time and effort. Leasing can therefore provide a "one-stop-shop" for both the purchasing and financing of equipment, which is a clear advantage and convenience for different firms.

There are a variety of benefits linked to the use of leasing. One of the key reasons why firms turn to leasing is that it allows firms to invest in fixed assets, financing up to 100% of the purchase price of an asset without requiring any additional guarantees or being able to use equipment or other assets without having to worry about considerations linked to being an owner, such as the disposal of the asset when it is no longer needed. This means that firms can better manage their working capital as payments are spread over the life of the asset. Additionally, leasing provides the possibility for firms to upgrade assets, thus giving them access to the latest, most efficient technology available, which in turn, keeps firms competitive. Lastly, leasing offers a great deal of flexibility as clients can often change the length of the contract to match their asset usage needs.

A lease can also be accompanied by an array of services, including insurance and maintenance of the asset, thus allowing clients to effectively outsource all of their asset related needs to the lessor who provides one convenient package. Moreover, depending on local fiscal treatments, leasing can also be beneficial from a tax point of view. For small and medium enterprises (SMEs) with high growth potential, but little history, leasing can be the only source of funding available to help them finance their development, due especially, to the fact that it is one of the most price competitive forms of financing. On the whole, lessors can provide finance in circumstances where traditional bank loans would not be granted as lessors have greater security due to the ownership of the asset.

In Europe, the use of leasing is becoming increasingly popular, particularly with SMEs. In 2010, 40%[1] of SMEs used leasing, which is greater than SMEs' use of any other individual form of bank lending. Additionally, the penetration rate (the share of European investment financed through leasing) amongst SMEs was 16,7% and is expected to rise to 18,6% in 2011. At the EU level, this means that leasing was responsible for financing just over €100 billion of SME investment in fixed assets in 2010 and this is expected to increase to €112,5 billion in 2011.

1. Source: Oxford Economics, "The Use of Leasing Amongst European SMEs", November 2011.

# Glossary

## Leasing Companies According to Shareholder Structure

In the profile of leasing firms active on a market, a “bank-related” leasing company either has a banking license in its own right or is part of a banking group. A captive company is a leasing company owned by a manufacturer or dealer.

## New Business/New Volumes

New business is total lease production for the year excluding VAT and finance charges.

## Outstandings

Initial value of assets minus depreciation to date or, if unavailable, amount of outstanding capital due on contracts.

## Asset Categories

*Machinery and Industrial Equipment*
Includes all types of machinery/equipment be they for commercial, industrial or agricultural use. Harvesters, tractors and earth movers, as well as other “wheeled” assets that are not registered (i.e., do not have a license plate) are included under this section and not under “Commercial Vehicles”.

*Computers and Business Machines*
Includes all IT equipment and other business machines such as photocopiers, etc.

*Commercial Vehicles*
Includes all registered commercial vehicles, regardless of their weight. This section therefore includes both light commercial vehicles (typically vans or vehicles which weigh less than 3.5 tonnes) as well as other, heavier commercial vehicles (i.e., trucks, trailers, busses, which weigh more than 3.5 tonnes).

*Motorcars*
Includes new and used cars, be they for private or business use (motorcycles as well as caravans are included here, too).

*Real Estate*
Includes all types of buildings or dwellings, be they for commercial, industrial or private use. Apartments, office buildings, hotels, retail outlets, to name a few.

# Notes

Figures shown in this publication relate to leasing defined in its widest sense, i.e. products known locally as hire purchase, finance leases and operating leases. Long term rental is also considered as leasing. It should be noted that there is no international or European definition of leasing, apart from that given in IAS17, the international accounting standard for leases. Local definitions of leasing products may vary according to the local legal, taxation or accounting framework as shown in this publication.

Please note that where percentage figures are used in new volume breakdowns, totals may not add up to 100% due to rounding.

Figures are provided by Leaseurope's Member Associations in local currency and converted into Euros using the yearly average exchange rate taken from Eurostat.

Growth rates are calculated based on the new leasing volumes figures provided by Leaseurope's Member Associations in Leaseurope's 2009 and 2010 Annual Statistical Enquiries as well as Leaseurope's 2010 and 2011 Biannual Statistical Enquiries. Additionally, they are adjusted for exchange rate fluctuations.

In countries where there is more than one Member Association reporting, there may be some overlap in data reported to Leaseurope.

Lastly, as Leaseurope does not have a Maltese general leasing or long term automotive rental association, Malta will only have a KPMG section to its chapter.

# Leaseurope Member Associations taking part in the 2010 Annual Statistical Enquiry*

Austria: Verband Österreichischer Leasing-Gesellschaften
Belgium: Association Belge de Leasing
Bulgaria: Bulgarian Association for Leasing
Czech Republic: Czech Leasing & Finance Association
Denmark: Finans og Leasing
Estonia: Estonian Leasing Association
Finland: Federation of Finnish Financial Services
France: Association Française des Sociétés Financières and Fédération Nationale des Loueurs de Véhicules
Germany: Bundesverband Deutscher Leasing-Unternehmen e.V.
Greece: Association of Greek Leasing Companies
Hungary: Hungarian Leasing Association
Italy: Associazione Italiana Leasing – ASSILEA and ANIASA
Latvia: Association of Latvian Commercial Banks – Leasing and Factoring Committee
Luxemburg: Fédération Luxembourgeoise des Loueurs de Véhicules
Netherlands: Nederlandse Vereniging van Leasemaatschappijen and Vereniging van Nederlandse Autoleasemaatschappijen
Norway: Finansieringsselskapenes Förening
Poland: Polish Leasing Association
Portugal: Associação Portuguesa de Leasing, Factoring e Renting
Romania: Leasing and Non-Banking Financial Services Association
Serbia: Association of Leasing Companies in Serbia
Slovakia: Association of Leasing Companies of Slovak Republic
Slovenia: Bank Association of Slovenia's Leasing Committee
Spain: Asociación Española de Leasing y Renting and Asociación Española de Renting de Vehículos
Sweden: Association of Swedish Finance Houses – AFINA, regrouping of Finansbolagens Förening and Svenska Bankföreningen
Switzerland: Schweizerischer Leasingverband
Ukraine: Ukrainian Union of Lessors
United Kingdom: Finance & Leasing Association

* For the purposes of this publication, short term automotive rental associations figures have not been shown.
A full list of Leaseurope members can be found on the Federation's website at www.leaseurope.org.

# Leaseurope Member Associations taking part in the 2011 Biannual Statistical Enquiry*

Austria: Verband Österreichischer Leasing-Gesellschaften
Belgium: Association Belge de Leasing
Bulgaria: Bulgarian Association for Leasing
Czech Republic: Czech Leasing & Finance Association
Estonia: Estonian Leasing Association
Finland: Federation of Finnish Financial Services
France: Association Française des Sociétés Financiaires and Fédération Nationale des Loueurs de Véhicules
Germany: Bundesverband Deutscher Leasing-Unternehmen e.V.
Greece: Association of Greek Leasing Companies
Hungary: Hungarian Leasing Association
Italy: Associazione Italiana Leasing – ASSILEA and ANIASA
Latvia: Association of Latvian Commercial Banks – Leasing and Factoring Committee
Netherlands: Nederlandse Vereniging van Leasemaatschappijen
Norway: Finansieringsselskapenes Förening
Poland: Polish Leasing Association
Portugal: Associação Portuguesa de Leasing, Factoring e Renting
Romania: Leasing and Non-Banking Financial Services Association
Russia: United Leasing Association of Russia
Serbia: Association of Leasing Companies in Serbia
Slovakia: Association of Leasing Companies of Slovak Republic
Slovenia: Bank Association of Slovenia's Leasing Committee
Spain: Asociación Española de Leasing y Renting
Sweden: Association of Swedish Finance Houses – AFINA, regrouping of Finansbolagens Förening and Svenska Bankföreningen
United Kingdom: Finance & Leasing Association

* For the purposes of this publication, short term automotive rental associations figures have not been shown.
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# 02
# Accounting for Leases under IFRS

# Accounting for Leases under IFRS

KPMG
cutting through complexity

Currently, the International Financial Reporting Standard (IFRS) for leasing is the International Accounting Standard 17 (IAS 17) – Leases. However, this may change in the future as the International Accounting Standards Board and the US Financial Accounting Standards Board (the Boards) have been working jointly on a project for nearly 6 years (the Leases project) to develop a converged standard on lease accounting by lessees and lessors that would improve the financial reporting of lease contracts. A joint exposure draft (ED) on lease accounting was issued in August 2010 by the Boards which generated huge interest and attracted nearly 800 comment letters. The Boards have since made several tentative decisions that will most likely change the proposals in the original ED. The discussions are still ongoing and the IASB is aiming to publish a revised exposure draft in the second half of 2012.

## Types of Transactions covered by IAS 17

Under IAS 17, a lease is defined as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. Title to the asset may or may not transfer to the lessee at the end of the lease.

There is no distinction between hire and operating leases; any transaction which involves the hire of a specific asset falls within the definition of a lease. It therefore includes the short-term charter hire of assets such as ships and aircraft. Leases of land and buildings are also included.

IFRS contains three other pieces of guidance - issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor, the Standing Interpretations Committee (SIC), on what types of transactions fall within IAS 17:

*IFRIC 4 - Determining Whether an Arrangement Contains a Lease.*
This interpretation gives guidance as to when a transaction that is not legally a lease contains elements that meet the definition of a lease and so should be accounted for under IAS 17. An example of such a transaction is a service contract that also conveys the right to use an asset to the purchaser of those services. Determining whether an arrangement is, or contains, a lease is based on an assessment as to whether:

- fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and
- the arrangement conveys a right to use the asset. This depends on whether the purchaser of the services has the right to control the use of the underlying asset.

*IFRIC 12 - Service Concession Arrangements*
This interpretation deals with public-to-private service concession arrangements in which the public sector controls or regulates the services provided with the infrastructure and their prices, and controls any significant residual interest in the infrastructure. Any service concession arrangements within the scope of IFRIC 12 are excluded from the scope of IFRIC 4 to eliminate the possibility of entities having a choice of accounting treatment for similar arrangements.

*SIC-27 - Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

The key aim of this interpretation is to ensure that a transaction or series of transactions involving the legal form of a lease are accounted for in accordance with their economic substance. Where the overall effect cannot be understood without reference to the series of transactions as a whole and where the arrangements do not in substance convey the right to use an asset, accounting for each separate leg of a series of transactions might not lead to the transactions being accounted for in accordance with their substance, and in such cases SIC-27 requires that IAS 17 is not applied. Examples of transactions that could be affected by the provisions of SIC-27 include certain lease-in, lease-out structures and certain sale and finance leaseback transactions. The accounting for such leases is outside the scope of this chapter.

## Lease classification

Under IAS 17, leases are classified as either finance leases or operating leases. The classification affects how lessors recognise and measure the leases in their statements of financial position and their income profile. For lessees, the classification affects whether the lease would be recorded in the balance sheet and the lessees' income profile.

Under IAS 17, a finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. In other words, the key risks being retained by the lessor are financing risks rather than risks associated with the asset being financed. All other leases are operating leases.

IAS 17 states that the lease classification depends on the substance of the transaction rather than the form of the contract and on an assessment as to the extent to which risks and rewards incidental to ownership of a leased asset are transferred. The classification is therefore judgmental rather than based on detailed rules.

IAS 17 does, however, give indicators to assist with this classification. It gives the following examples of situations which would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised
- The lease term is for the major part of the economic life of the asset even if title is not transferred
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

Generally, the presence of any one of the above indicators would normally lead to a lease being classified as a finance lease. Ultimately, the lease classification should be based on an overall assessment of whether substantially all the risks and rewards incidental to ownership of the leased asset have been transferred from the lessor to the lessee.

IAS 17 also gives the following indicators of situations which individually or in combination could lead to a lease being classified as a finance lease:

- If the lessee can cancel the lease, but the lessor's losses associated with the cancellation are borne by the lessee
- Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than the market rent.

IAS 17 does not provide a hierarchy to be applied when evaluating the above eight indicators, and these indicators may not be conclusive. If there are other facts or features that transfer substantially all risks and rewards incidental to ownership of the leased asset to the lessee, the lease is classified as a finance lease.

Under IAS 17, where a lease contains both land and buildings, the land element and the building element should be classified separately. A significant amendment to IAS 17 was made in previous years which became effective for annual reporting periods beginning on or after 1 January 2010. Before the amendment, IAS 17 stated that leases of land would normally be classified as operating leases unless title is expected to transfer to the lessee at the end of the lease. Under the amended IAS 17, normal lease classification criteria have to be applied to all leases of land. This means that a long lease of land may be required to be classified as a finance lease, even if at the end of the lease term title will not pass to the lessee. The rationale for this is that in such arrangements substantially all risks and rewards incidental to ownership of the leased land are transferred to the lessee and the present value of the residual value of the leased land is considered negligible. This amendment has to be applied to both future and unexpired existing leases.

Lease classification should be carried out at the inception date of the lease. This is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. The classification is not subsequently changed if there are changes in estimates (for example, changes in the residual value estimate) or changes in circumstances (for example, default by the lessee). However, if at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, the revised lease agreement may have to be treated as a new agreement and this could affect the classification of the lease.

## Key terms used by IAS 17

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
- for a lessor, any residual value guaranteed to the lessor by:
- the lessee;
- a party related to the lessee; or
- a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

If the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable such that it is reasonably certain, at the inception of the lease, that the option will be exercised, the option price should be included in the minimum lease payments.

As noted above, minimum lease payments exclude the following:

- Contingent rent - This is defined as the portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest, tax variation amounts)
- Costs for services - For example maintenance costs and expenses borne by the lessor such as road fund tax for a leased vehicle
- Taxes to be paid by and reimbursed to the lessor - For example VAT

The discount rate to use in present valuing the minimum lease payments would generally be the interest rate implicit in the lease. This is defined as the discount rate that, at the inception of the lease, causes the aggregate present value of:

- the minimum lease payments; and
- the unguaranteed residual value to be equal to the sum of:
  - the fair value of the leased asset and
  - any initial direct costs of the lessor.

Initial direct costs are directly attributable incremental costs incurred in negotiating and arranging the lease, except for such costs incurred by manufacturer or dealer leases.

## Lessor accounting

Once the lease classification has been determined, the relevant accounting treatment for each classification under IAS 17 follows:

***Finance leases***

Lessors should recognise assets held under a finance lease in their balance sheet as finance lease receivables at an amount equal to the net investment in the lease. Income is recognised so as to give a constant periodic rate of return on the lessor's net investment in the lease.

The net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

The gross investment in the lease is the aggregate of:

- the minimum lease payments receivable by the lessor, and
- any unguaranteed residual value accruing to the lessor.

Given the definition of interest rate implicit in the lease, the result is that the amount initially recognised equals the fair value of the asset plus any initial direct costs.

In the case of a finance lease, the transaction is in substance the provision of finance and income is recognised in a similar manner to interest.

Over the lease term, interest accrues on the net investment. The receipts under the lease are allocated between reducing the net investment and recognising finance income so as to produce a constant rate of return on the net investment.

*Operating leases*
In the case of an operating lease, the lessor is essentially taking asset risk and so this is reflected in the accounting by treating the leased asset as a property, plant and equipment (PP&E). The accounting for that asset is the same as for any other PP&E – generally this would mean depreciating the asset on a straight-line basis. The earnings from that asset (i.e. rentals) are generally recognised on a straight-line basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

## Lessee accounting

Similar to the accounting applied by lessors, the accounting for leases is determined by the classification of the lease into either operating or finance lease. The following sets out the accounting by lessees under IAS17.

*Finance leases*
Where an asset's use has been obtained under a finance lease, it should be capitalised by the lessee i.e. recorded in the lessee's balance sheet as PP&E and as an liability to pay future rentals. It should be capitalised at the date of the lease commencement i.e. the date when the lessee is entitled to exercise its right to use the leased asset.

Initially the value of the PP&E and finance lease liability should be the fair value of the asset or, if lower, the present value of the minimum lease payments. This present value should be calculated using the interest rate implicit in the lease if this is practicable to determine and if not, the lessee's incremental borrowing rate shall be used.

The asset is then depreciated in the same way as for any other PP&E over the shorter of the term of the lease and the asset's useful life. The lease term, for this purpose, includes any secondary periods if exercise of those secondary periods is reasonably certain. If at inception of the lease term it is reasonably certain that the lessee will obtain ownership of the leased asset by the end of the lease term, then the asset should be depreciated over the expected useful life of the asset.

The finance charges on the liability should be allocated to accounting periods so as to give a constant periodic rate of charge on the remaining liability.

*Operating leases*
Operating leases are not capitalised by lessees and remain 'off-balance sheet'. The rentals are generally charged on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not made on such a basis. The only amounts on the lessee's balance sheet will simply be any rentals accrued or prepaid at the balance sheet date.

Examples of where the lessee would recognise rentals as they arise rather than on a straight line basis would be where:

- The rentals vary with usage
- The rentals vary in line with an inflation index or market rates.

There may be instances that when negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent. Guidance on treatment of such incentives are found under SIC-15 Operating Leases - Incentives which require the benefit to be recognised over the lease term.

A payment may be made on entering into or acquiring a leasehold that is accounted for as an operating lease. This payment should be treated as prepaid lease payments and be amortised over the lease term in accordance with the pattern of benefits provided (normally straight-line).

## Future changes - the joint IASB/FASB Leases project

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are currently carrying out a joint project to develop a new lease accounting standard (the Leases project). To-date, both the IASB and FASB (the Boards) have issued the following:

- Discussion Paper Leases: Preliminary Views in March 2009 (DP) which sets out the Boards' preliminary views on lessee accounting and a high level overview of possible approaches to lessor accounting to be addressed.
- Exposure Draft ED/2010/9 Leases (the ED) published in August 2010 which proposes new models for both lessor and lessee accounting

Following the publication of the ED, the Boards received almost 800 comment letters. While some constituents were supportive of the Boards' efforts to develop a single, principles-based, converged and less complex lease accounting standard, almost all expressed significant concerns over the technical content and complexity of the proposals in the exposure draft. The Boards have since then held several discussions and reached several tentative decisions that significantly change the proposals in the original ED. Discussions are still ongoing and the Boards are aiming to publish a revised joint ED in the second half of 2012.

Based on the key themes of the ED and the Boards' tentative decisions, the Leases Project can be summarised as follows:

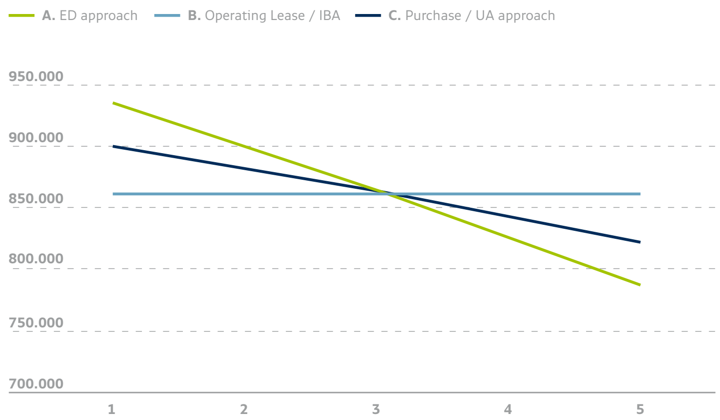
- **All leases (except for short term leases) would be recorded on the balance sheet of lessees.** The effect of bringing operating leases onto the balance sheet of lessees as a Right-of-Use (ROU) asset and the recognition of a lease liability will increase dramatically lessee's gearing, key ratios and covenants. The original proposal in the ED will also result in the front-loading of interest expense for the lessee which would have consequences for profitability ratios, EBITDA, and interest cover. The Boards discussed this issue in February 2012 but have not resolved the issue. The Boards are considering the following three possible approaches:

  (a) Boards' current proposal under the original ED
  Front-loaded pattern of expense for lessees arises when a lessee recognises a right-of-use (ROU) asset, which is typically amortised on a straight-line basis, and a liability to pay lease rentals, which would be accounted for like a loan with higher interest charges in the early years. The combined effect is a front-loaded expense in the income statement, even if the lessee pays the same amount of rent each year.

  (b) An interest-based amortisation (IBA) approach
  Under the IBA approach, the lessee would amortise its ROU asset using an interest method. This would produce a back-loaded amortisation charge which will go some way to counterbalancing the front-loaded interest charge. The result is an expense profile that is similar to that under current operating lease accounting i.e. a straight-line expense profile. In addition, this proposal results in the retention of a lease classification test to identify the leases to which the IBA approach would be applied.

  (c) An underlying asset (UA) approach
  Under the UA approach, the lessee would amortise its ROU asset to reflect consumption of the underlying asset during the lease term and the lessor's return on the residual asset. If consumption of the underlying asset during the lease term is low (e.g. a real estate lease), then this would produce a back-loaded amortisation charge which will go some way to counterbalancing the front-loaded interest charge. If consumption of the underlying asset is high, then the front-loading effect would persist. The result is an expense profile that is similar to that for a purchased asset financed by a loan. As the profile of lease expense depends on the extent to which the underlying asset is consumed, there is no need for a lease classification test.

  The diagram below is an illustrative example of each approach proposed by the Boards:

  The Boards intend to perform further research and outreach to test the applicability of approaches B and C and it is also observed from the Boards' discussions that there is clear division between the IASB and FASB as the IASB favours the UA approach while the FASB favours the IBA approach. Such division will likely increase the uncertainties of the Leases project.

- **Lessor's model will be the receivable and residual approach for most assets except investment properties and short term leases.** Under this approach, the lessor recognises a lease receivable representing its right to receive lease payments, and a residual asset representing its rights in the underlying asset at the end of the lease term. The lessor may recognise a profit on commencement of the lease and would also recognise interest income on the lease receivable and income through accretion of the residual asset. However, the Boards have tentatively decided to exclude leases of investment properties and short term leases from the scope of the receivable and residual model; the lessor would typically recongise lease income on such leases on a straight line basis, similar to current IAS 17 operating lease accounting.

- Inclusion of contingent rents either based on an index or rate (spot rate)
  Lessees and lessors would include contingent rents based on an index or a rate in the lease liability/receivable based on the current value of the index or rate.

Periodic subsequent reassessments of the lease term, contingent rents, residual value guarantees, termination penalties and purchase options are required

Subsequent remeasurements of lease balances may result in volatility in the income statement and balance sheet.

It is also worth mentioning that the changes in accounting will have an impact of tax particularly for those countries where accounts prepared under IFRS are used for tax, such as in the United Kingdom. Currently in the UK, until the tax legislation can be updated to take account of the new accounting, the tax authorities approach is to 'freeze' taxation by reference to the old accounting standards under IAS 17 as the reference point for tax. In the short term this is likely to require the preparation of 'shadow' accounts for the purposes of preparing tax computations. It will also introduce a difference between reported IFRS balances and tax base leading to potential deferred tax implications. The tax impact in other jurisdictions, where accounts prepared under IFRS are used for tax, could be different.

## Next steps

The IASB work plan no longer states when a final leases standard will be issued. In addition, other topics that the Boards plan to discuss before the publication of the revised ED include:

- lease classification for lessees, if required;
- definition of investment property;
- remaining presentation and disclosure matters for lessees and lessors;
- disclosures about the fair value of investment property;
- remaining lessor accounting matters under the receivable and residual model; and
- cost/benefit considerations of the proposals as a whole.

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The following pages are an extract of the publication entitled European Leasing. Individual country chapters detailed in the full publication have not been shown here. For further information, please contact: Andrea Wesolowski at a.wesolowski@leaseurope.org.

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