

### Special issue

*In this special edition of Leaseurope inside, we have asked the International Accounting Standards Board (IASB) to explain their proposals for a draft standard on how businesses should account for their lease and rental contracts. By doing so, we hope to ensure that the entire European leasing community is fully informed, in straightforward language, of what the standard setters are proposing. We are grateful to the IASB staff for accepting our invitation to share this useful overview of the proposals with the European leasing industry.*

┌ We have also taken this opportunity to provide Leaseurope **inside** readers with some initial views from those within the leasing industry who are closest to the proposals. The Chair of Leaseurope's Accounting Committee, Mark Venus, gives a high level overview of what he sees as being the major issues that have emerged from the leases project. Julian Rose, Head of Asset Finance at the UK Finance and Leasing Association (FLA) looks at the very many open questions and practical issues that still will need to be addressed before the lease accounting story comes to an end. Jacqueline Mills from Leaseurope considers how the proposals have evolved from Discussion Paper to Exposure Draft phase and discusses the need to balance the benefits and costs of the proposals.

Leaseurope, together with its member associations, is currently preparing a European leasing industry reaction to the recently issued [Leases Exposure Draft](#) and will seek to engage with the IASB, FASB and other key stakeholders at European level, to ensure that the industry's views on this important project are heard loud and clear.

**The proposals and their implications will be discussed at length during our forthcoming Annual Convention in Hamburg on 30 September and 1 October 2010. We hope that you will be able to join us for this unmissable opportunity to learn more about future lease accounting and to better understand how this may affect the market.**

┌ Forty-eight months. Forty-eight months have passed since the International Accounting Standards Board (IASB) decided to add lease accounting to its work programme. These 1400+ days will not have sufficed for the IASB to produce a high quality proposal that meets the set objectives of comparability, consistency, transparency and efficiency.

This is no surprise as the standard setters appear to have mostly ignored comments they received following the publication of their Discussion Paper in March 2009, probably by fear of missing the June 2011 deadline agreed upon by the IASB and its US counterpart (FASB) to converge their standards.

The reactions that have followed the recent release of the IASB/FASB Exposure Draft show that many of the concerns expressed by leasing companies are shared by other parties, including their customers. This should be even clearer once PwC releases the results of the survey it just carried out among lessees as regards the

expected impact of the IASB/FASB proposal. This is a positive development as too few lessees had expressed themselves on the subject matter so far. Hopefully many more will contribute to the debate by sending their comments on the Exposure Draft by the end of the consultation period (15 December).

Although standard setters are already fully aware of our views, we will continue to voice the concerns of the leasing industry, put forward the industry position and hammer out workable alternative solutions.

The draft standard is extremely and unnecessarily complex. As astonishing as it may be the proposal has never been subject of any cost/benefit analysis. This is a matter of utmost concern that now needs to be raised with European and national policymakers at the most senior level. The importance of leasing to the real economy, the many benefits of usage over ownership and the fact that the leasing industry is supportive of increased

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transparency of financial information should be made very clear to them on that occasion.

The following months will be crucial. Leaseurope is determined to continue leading the debate on the issue, in close cooperation with its international counterparts. At the same time we urge all national leasing associations in Europe to develop a clear lobbying strategy and action plan for the months to come. For in the absence of very concrete actions taken at national level, Leaseurope's efforts will be in vain, to the detriment of the leasing industry and the economy it fuels.



**Tanguy van de Werpe,**  
Leaseurope  
Director General

## Proposals to Improve Lease Accounting

by Barbara Davidson, Technical Manager, IASB Staff

### Introduction >

*For many years, academics, standard-setters and investors, among others, have been debating the appropriate model for lease accounting. Investors especially have long been dissatisfied with the accounting because it does not provide the information they need to analyse financial statements.*

*We are getting closer to a solution to this problem thanks to a joint project by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). In 2006, the boards agreed to add a lease project to their technical agendas. The project is part of the boards' joint work programme towards convergence, with an estimated completion date of 2011.*

*A large step towards achieving that goal was the publication of the exposure draft Leases on 17 August 2010. The exposure draft proposes changes to today's lease accounting model in order to address the concerns that have been raised over the years and to provide users with better information about the cash flows arising from lease contracts.*

*This article outlines the problems with the current lease accounting model and how the proposals address these problems. It discusses the proposed lessee and lessor models, the treatment of contingent features, common questions on the proposals and the next steps in the process.*



Barbara  
Davidson  
Technical  
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### What are the problems with the current accounting model?

#### Lessees

Today there are in effect two different accounting models for leases—operating leases and finance leases. The model used depends on whether the lease has transferred 'substantially all the risks and rewards incidental to ownership of an asset'<sup>1</sup> to the lessee. While the criteria for making the distinction between operating and finance leases are based on this principle, many companies use quantitative criteria imported from the US lease accounting rules to determine the accounting split.

The two models produce significant differences in financial statements. If a lease meets the definition of a finance lease, a lessee will record the actual asset under the lease (eg an aircraft) and a liability for its lease payments. It will also record depreciation and interest expense. For an operating lease, the lessee has only to record rent expense over the life of the lease. It does not record any assets and liabilities resulting from the lease. Thus the two models can result in different accounting for similar transactions, which impairs comparability, and affects the lessee's leverage ratios and earnings. The difference also encourages entities to structure a lease to obtain a particular accounting outcome.

Because operating leases do not result in the recognition of assets or liabilities, investors have incomplete information. Investors think that assets and liabilities arising from operating lease contracts should also be recorded on the balance sheet (statement of financial position) because they represent a form of leverage for the lessee. Consequently, for many years investors have made adjustments to reflect the

assets and liabilities arising from the leases for their analysis of a lessee's balance sheet and profit or loss (statement of comprehensive income). Often the adjustments are based on estimates from the footnotes, which may not give complete information.

#### Lessors

Most of the criticisms of current lease accounting relate to the treatment of operating leases in the financial statements of lessees. In addition, many more companies are affected by lessee accounting than by lessor accounting. Some have therefore questioned whether the IASB should propose changes to lessor accounting.

Because of this the IASB originally focused on changes to the lessee accounting model, as detailed in the discussion paper *Leases: Preliminary Views* published in March 2009. However, many respondents to the discussion paper (including many from the leasing industry) were concerned that the IASB was not addressing the lessee and lessor models together. The lessee model proposed in the discussion paper was inconsistent with the current lessor model. Consequently, there were requests that the IASB should develop a consistent model for both lessees and lessors. The IASB agreed, and the proposed changes include both lessee and lessor accounting.

### What is being proposed?

#### Lessee accounting

The flaws in today's model necessitate some significant changes.

The proposals address those flaws as follows:

- All lease contracts would be recorded on the balance sheet.
- There would be no accounting difference between an operating lease and a finance lease.
- Investors would be given more complete and useful information.
- The need for investors to make additional adjustments would be eliminated or greatly reduced.

Continued on next pages >

## Proposals to Improve Lease Accounting

by Barbara Davidson, Technical Manager, IASB Staff // Continued

Under the proposals, lessees would account for all relevant leases using a single model (the 'right-of-use' model). The principle for this is that a lease results in a lessee's unconditional right to use an asset, and an unconditional obligation to make lease payments. As such, when a lessee enters into a lease it would record the asset that arises from the lease contract (the 'right-of-use' asset). It would also record its liability to make lease payments that result from the lease.

These assets and liabilities are measured at the present value of the lease payments, discounted at the lessee's incremental borrowing rate. This is the rate that the lessee would pay to borrow a similar amount of money over a similar period of time to finance the purchase of a similar asset (with that asset as collateral for the amounts 'borrowed'). Of course, a lessee can use the rate charged in the lease if it knows that rate since the incremental borrowing rate and the rate charged in the lease should be the same.

The right-of-use asset would be subsequently amortised on a systematic basis over the life of the lease (or, if shorter, the life of the underlying asset). It would be presented on the balance sheet in the category of property, plant and equipment. While not the same as the underlying asset (eg the ship, aircraft or car), the right-of-use asset would be presented on the balance sheet together with the same class of underlying assets owned by the lessee, so that investors can see all the lessee's assets whether leased or owned. The right-of-use asset would be subject to impairment tests. In addition, preparers that use International Financial Reporting Standards (IFRSs) could revalue the right-of-use asset even if there is no active market. This is to maintain consistency with their ability to revalue owned property, plant and equipment under current IFRSs.

The lessee's liability is seen as a financing liability. Consequently, the lessee subsequently recognises interest expense on this liability.

### Lessor accounting

The proposed lessor model is also a right-of-use model. The concept here is that the lease creates an unconditional right to receive lease

payments from the lessee. The lessor will record a 'right to receive lease payments' upon transferring the right to use the underlying asset to the lessee. This right to receive is measured at the present value of the lease payments, discounted using the rate the lessor is charging in the lease. The lessor recognises interest income on this asset over the term of the lease.

When discussing the lessor model, the IASB decided that a single approach to accounting for the underlying asset did not work for all leases. This is because of the different economic characteristics in lease contracts from the lessor's perspective as well as lessors' different business models. The proposals must be appropriate for different types of lessors.

Therefore, the IASB proposes that the lessor's accounting for the underlying asset would depend on its exposure to significant risks or benefits of that asset (either during or after the expected lease term). If the lessor does not retain exposure it would use a 'derecognition approach'. If the lessor retains exposure it would use a 'performance obligation' approach.

The derecognition approach results in the lessor removing the portion of the underlying asset that relates to the lessee's right-of-use, and retaining a residual asset on its books. There could be a gain on commencement of the lease under this model. The residual asset is not subsequently remeasured (unless the lease includes options to extend or terminate). Under the performance obligation approach, the underlying asset remains on the books. The lessor records a lease liability that represents

its obligation to allow the lessee to use the asset over the term of the lease. The lessor will discharge that liability into lease income over the life of the lease.

### Complex features

Lease contracts can also contain complex features such as options to extend the lease term and contingent rentals. For example, a simple five-year lease may include an option to extend for five years, giving the lessee the option to continue the lease after the minimum contractual period. These options are often included in leases to give lessees flexibility. Contingent rentals are payments that are based on contingent items such as the distance driven in a car, the sales made from a particular retail store or the changes in a specified index (eg the consumer price index). Contingent rentals may comprise the whole lease payment or may be in addition to a minimum fixed payment.

### Options to extend

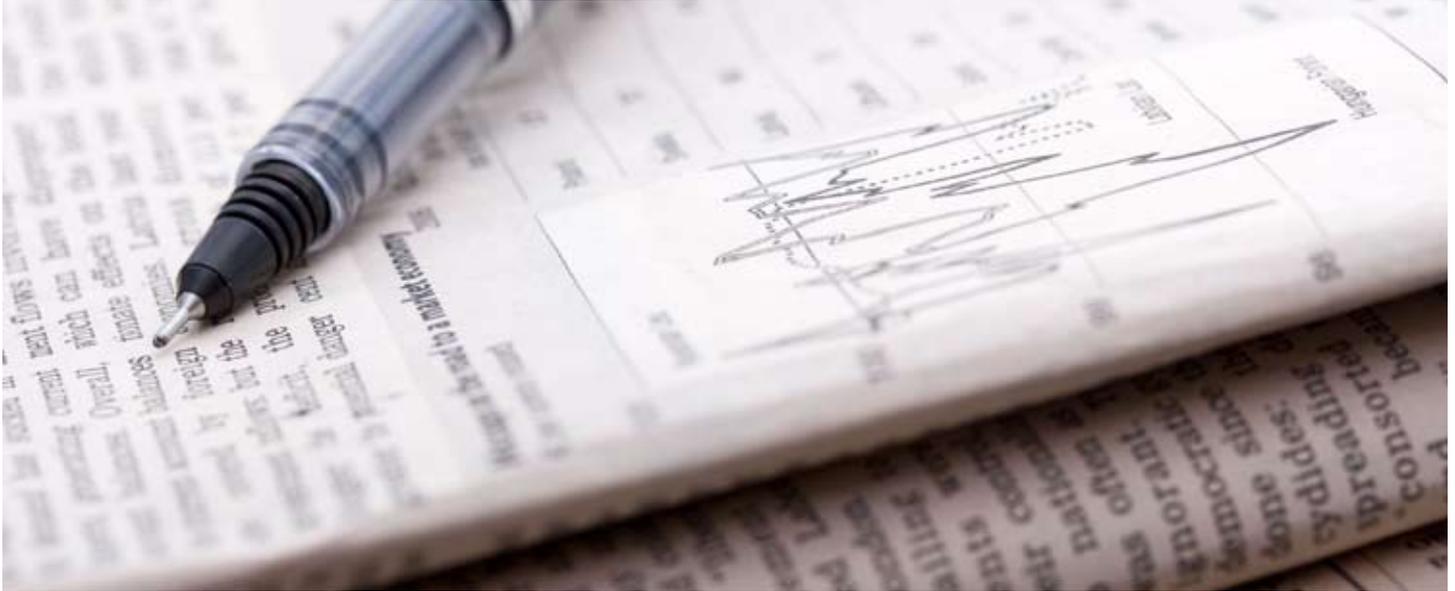
The IASB considered requiring separate accounting for options to extend in lease contracts. But there was concern that separately accounting for these items would be too complex. For example, the interrelationship between an option to extend and a residual value guarantee creates complexities in the measurement that may not provide sufficient useful information to justify the burden of valuing these items separately. The IASB also discussed ignoring or only disclosing these items. But this could result in understated assets and liabilities as well as create structuring opportunities. Therefore, despite the difficulty in determining the most appropriate treatment the IASB decided it was important to include the expected cash flows from optional periods in the recognised lease assets and liabilities.

Under the proposals, preparers would estimate the longest possible lease term that is more likely than not to occur and record the related asset/liability on the basis of that estimate. Thus for a simple five-year lease with an option to extend for another five years, the lessee and lessor would have to estimate the probability of exercising the option. If the probability of a five-year life is 80 per cent

There would be no accounting difference between an operating lease and a finance lease

### Proposals to Improve Lease Accounting

by Barbara Davidson, Technical Manager, IASB Staff // Continued



and the probability of a ten-year life is 20 per cent, the lease asset and liability would only include five years of lease payments. Using a probability weighted approach for options was also considered. However, the concern that an asset could be recorded over a lease term that could never exist (say a six-year term for the above lease) caused the IASB to move away from probability weighted accounting for these types of options.

#### Contingent rentals

The IASB also considered excluding the effects of contingent rentals from the measurement of the assets and liabilities recognised by lessees and lessors. Some were concerned that contingent rentals did not meet the definition of a liability for the lessee or an asset for the lessor because they do not exist until payment is due. However, in the IASB's view an asset and a liability exist upon entering into a lease; it is merely the amount of the asset and liability that is uncertain. In addition, excluding contingent payments could lead to understatement of the related assets and liabilities, which would not provide useful information to investors, and could again present structuring opportunities.

Therefore, contingent rentals are included in the measurement of the lease payments using a probability weighted approach for a reasonable number of outcomes. For example, if a car lease

included payments based on usage of the car, the lessee would have to weight a reasonable number of outcomes—say, the probability of driving the car 5 000 km, 10 000 km or 15 000km. The amounts in this calculation would be included in the present value of the lease payments. Under the proposals, lessees always have to estimate these amounts when measuring their right-of-use asset and their liability. To maintain consistency with the IASB's proposals on revenue recognition, however, lessors can include only amounts that could be measured reliably.

#### Reassessment

The proposals require preparers to reassess both the lease term and estimates of contingent rentals if changes in facts or circumstances indicate that there is a significant change in the assets or liabilities since the last reporting period.

Changes in estimates would be treated as follows: (see Figures 1 and 2)

Figure 1

	Lessees
Changes in estimates related to:	Adjust liability to make lease payments and
Options to extend	right-of-use asset because more or less of the asset is transferred
Past and current period contingent rentals	profit or loss because right-of-use asset was already used
Future contingent rentals	right-of-use asset because change relates to less or more asset to be used in the future

Figure 2

	Lessors	
Changes in estimates related to:	Derecognition: Adjust right to receive rentals and	Performance obligation: Adjust right to receive rentals and
Options to extend	residual asset and amount derecognised because more or less is transferred	lease liability because the liability is satisfied or more is taken on
Contingent rentals	profit or loss	lease liability to the extent the liability is not satisfied, profit or loss to the extent liability is satisfied

## Proposals to Improve Lease Accounting

by Barbara Davidson, Technical Manager, IASB Staff // Continued

### Common questions

Below are some of the more common questions that arise related to the proposals:

**Question: Has the IASB considered the costs and benefits of applying these proposals, especially to shorter-term leases?**

**Answer:** Because of concerns around this the IASB has included simplified accounting for short-term leases (leases with a maximum possible term of twelve months or less). The IASB has also revised the requirement for reassessing changes in estimates from 'each reporting period' to 'when facts or circumstances indicate there would be a significant change in the asset or liability'. In addition, the IASB will review further the costs and benefits of implementing these proposals after receiving the results of the field work performed during the comment period.

**Q. Why are 'non-core' assets such as photocopiers in the proposals?**

**A.** The IASB could not find a conceptual justification for excluding 'non-core' assets. In addition, the leasing of such items could result in significant assets and liabilities for lessees, which is important information for investors.

However, as mentioned above, the IASB included a simplified approach for short-term leases, to ease the burden of applying the proposals. Materiality rules would also apply to these proposals as they do to all standards (ie the requirements need not be applied to immaterial items).

**Q. Why are there two approaches for lessors but only one for lessees?**

**A.** Two approaches better reflect the differences in the economic characteristics of a lease contract, as well as the effects of the business model, from a lessor's perspective. The IASB discussed using a single approach to lessor accounting but decided that no one approach worked for all leases. For example, the performance obligation approach does not provide

useful information for many manufacturers or banks. Derecognition does not provide useful information for some property leases and some shorter-term leases. However, from a lessee's perspective the IASB thinks that the proposed model (one approach for all leases) correctly reflects the assets and liabilities arising in all lease contracts.

**Q. Is the performance obligation approach inconsistent with the lessee accounting model?**

**A.** No. A right to receive lease payments arises when the lessor transfers to the lessee the right to use the asset. However, under the performance obligation approach, the underlying asset is still under the control of the lessor because of the lessor's exposure to significant risks or benefits. The lease liability shows the obligation that the lessor has to permit the lessee to use its asset over the lease term.

**Q. Does the performance obligation model double-count the underlying asset?**

**A.** No. Because the underlying asset is still seen as the economic resource of the lessor, it remains on the lessor's balance sheet. The lessor must also record a liability to allow the lessee to use the asset, which could be seen as a restriction on the underlying asset. In addition, the IASB has proposed a linked balance sheet presentation for the underlying asset, lease liability and right to receive lease payments, which shows investors the interaction between these items.

**Q. What about service agreements? How are they dealt with under the proposals?**

**A.** In the proposals, the IASB has included IFRIC 4 *Determining whether an Arrangement contains a Lease*, which is already used in practice today. To the extent that an agreement is not a lease under IFRIC 4, the proposals would not apply. In addition, entities must also determine a split between lease payments and service payments for contracts that are lease agreements. Further guidance on this is included in the exposure draft.

### Scope

The scope of the proposals is very similar to that of the existing leases standard. The IASB is not including leases of intangible assets, as it hopes to address intangibles in general at a future date. Leases of biological assets (eg vineyards or livestock), as well as those in the extractive industries (eg mining), will continue to be accounted for under separate specialised standards.

The proposals will not cover contracts that are purchases or sales of items (ie leases that have a bargain purchase option or automatically transfer title). In addition, lessors that measure their investment properties at fair value under IAS 40 *Investment Property* are not within the scope of the proposals.

### Other items

The IASB recognises that the costs associated with applying the proposals to shorter-term leases may outweigh the benefits. It has therefore included an option to apply simplified accounting for short-term leases. Short-term leases are defined as leases with a maximum possible lease term of twelve months or less. For example, a six-month lease with an option to extend for three months is a short-term lease. However, a six-month lease with an option to extend for nine months is not a short-term lease because the maximum possible lease term is longer than twelve months.

Under the simplified accounting, lessees could ignore the effects of interest on short-term leases and record a gross asset and liability. Lessors would record lease payments in profit or loss over the lease term.

### What's next?

The comment period on the exposure draft ends on 15 December 2010. During this period the IASB and FASB are seeking views and suggestions on the proposed model. Both boards are inviting companies to volunteer to take part in fieldwork to assess the effect of the proposals, including the costs and benefits of implementation. They will also continue to discuss the proposals and any concerns or questions during this period.

### Proposals to Improve Lease Accounting

by Barbara Davidson, Technical Manager, IASB Staff // Continued

The boards will then redeliberate the proposals in the exposure draft. They intend to issue the new standard in Q2, 2011. The effective date of the proposals is still open and will be reviewed through a separate consultation. However, the boards realise that these proposed changes will take time to implement so they will allow companies sufficient time to prepare for the proposed changes.

#### Changes from the discussion paper

For those familiar with the discussion paper *Leases: Preliminary Views* published in March 2009, below (Figure 3) are some of the more significant changes from the original proposals in the discussion paper. These are based on feedback received and the boards' subsequent deliberations.

#### About the IASB

The IASB was established in 2001 and is the standard-setting body of the IFRS Foundation, an independent private sector, not-for-profit organisation. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that provide high quality transparent and comparable information in general purpose financial statements. In pursuit of this objective the IASB conducts extensive public consultations and seeks the co-operation of international and national bodies around the world. The IASB currently has 14 full-time members drawn from ten countries and with a variety of professional backgrounds. By 2012 the IASB will be expanded to 16 members. IASB members are appointed by and accountable to the Trustees of the IFRS Foundation, who are required to select the best available combination of technical expertise and diversity of international business and market experience. In their work the Trustees are accountable to a Monitoring Board of public authorities

To find out more about the IASB and the leases project please visit its website at <http://go.ifrs.org/leases>.

Figure 3

Topic	Discussion paper	Exposure draft
Lessor model	High level discussion only	Fully developed
Long-term leases of land	Had not been decided	Included in proposals
Short-term leases	Had not been decided	Simplified accounting
'Non-core' asset	Had not been decided	Included in proposals
Right-of-use asset	Revalue only if active market (IFRS only)	Can choose to revalue even if no active market (IFRS only)
Lessee discount rate	Incremental borrowing rate	Can use rate in lease if known
Reassess estimates	Every reporting period	If facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period
Sale and leasebacks	Had not been decided	If the transfer meets the definition of a purchase / sale, account for the transaction as a sale and leaseback. Adjust assets, liabilities, gains or losses to reflect market rentals.

#### About the Author

Barbara Davidson is a Technical Manager at the International Accounting Standards Board and oversees outreach on the lease accounting project. The views expressed in this article are her own and do not represent the views of the IASB. Organisations interested in arranging meetings to further discuss the lease project can contact Ms Davidson at [bdavidson@ifrs.org](mailto:bdavidson@ifrs.org).

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## The Leases Exposure Draft: Is it all it seems ?

By Mark Venus, BNP Paribas, Chair of Leaseurope's Accounting Committee



Mark Venus  
BNP Paribas  
Chair of Leaseurope's  
Accounting Committee

┃ In this issue of Leaseurope inside, the IASB has provided a cogent and well-written defence of the Leases Exposure Draft. Yet when one looks at the thinking that underlies the ED, the board's proposals are far from being as consistent and coherent as they would have us believe. Many elements of the proposals fail to meet the boards' objectives, to respect the board's conceptual framework, and to respect the reality of the leasing market.

### A lease is a lease (or is it ?)

All leasing professionals know, and this is a point that has been repeatedly made to the boards and staff, that leasing covers a spectrum of activity that runs from straight-forward leases with no or little additional services to outsourcing arrangements where the service provided is the key feature and the availability of assets is simply ancillary to the service. To simplify, at one end are 'in-substance purchases', at the other end are 'in-substance service contracts'.

Somewhere in this spectrum, a dividing line, or lines, needs to be drawn in order to reflect the differing economic characteristics of these arrangements. In current lease accounting standards, the line is drawn in the middle of the spectrum, such that operating leases are given similar treatment to service contracts, and finance leases are given similar treatment to asset purchases and financings.

The stated aim of the boards was to propose a unique accounting model for all leases, thus removing this frontier within leases. However, whilst conceivable, this creates the need to carefully define frontiers at each end of the lease spectrum, and the boards have failed to adequately meet this requirement.

Where leases are closer to asset purchases, the boards have simply stated that some leases are not leases any more (leases with automatic transfer of title and those with 'bargain' purchase options). Whilst such deals are undoubtedly similar to asset purchases, it is a giant step in logic to say that they are purchases. Until the lease has been paid in full and/or the purchase option exercised, the lessee does not have the same rights over the asset as does an asset purchaser, and all leasing professional know that today's 'bargain' purchase option is not always exercised tomorrow. The boards, who have recognised that purchase options do not form part of the lease payments but provide a means to terminate a lease, have not justified why leases with automatic transfer of title or 'bargain' purchase options should not be treated as leases until the point at which title is transferred. In reality, this distinction only emerged in the boards' thinking when they were seeking to alleviate some of the problems in revenue recognition associated with the Performance Obligation approach which they had invented.

At the other end of the leasing spectrum, the distinction between leases and service contracts has been insufficiently addressed by the boards, who have contented themselves with incorporating more or less the wording of IFRIC 4 into their proposed standard. Yet IFRIC 4 today fails to provide adequate answers to issues that arise when looking at capacity leases or leases where substitution of assets can occur. If the boards are prepared to say that some leases are not leases because they are purchases, why have they not addressed the issue of whether some leases are not leases because they are service contracts?

### Flexibility has value (or does it?)

The treatment in the ED of optional periods and contingent rentals flies in the face of intuition. A lessee who has agreed with his lessor to commit to usage of an asset for a fixed period, with a further period of potential usage at his option, and/or an adjustment of his rentals to cover more intensive usage of the asset, has negotiated a flexible deal that best fits his economic needs, precisely because he does

not know of what the future will be made. The boards are telling him, through their proposals for contingent rentals and optional periods, that he has got to guess what his future will be made of, account for it that way, and then re-adjust as the future becomes clearer over time. Why should flexibility be penalised by accounting complexity, and why should the value of flexibility be refused to a lessee who invests in negotiating the most appropriate deal for his particular circumstances?

The acting chairman of FASB has said that complex deals lead to complex accounting, but this ignores two key facts: extension options and contingent rentals are everyday features of lease agreements that nobody active in leasing considers as complex, and the boards' own conceptual framework is at odds with their proposals. The refusal of the boards to properly distinguish between variable rate rentals and contingent rentals, and a grossly exaggerated fear of structuring, lie behind this mistaken position, happily highlighted by the alternative view of one board member expressed in the Basis for Conclusions to the ED.

### Convergence is desirable (or is it ?)

The leasing industry certainly supports convergence between IFRS and US GAAP, but only if it leads to high-quality coherent standards. If convergence consists of papering over differences between IFRS and US GAAP, or seeking the lowest common denominator, then it cannot be considered as desirable. The boards have fallen into these traps in this project.

Continued on next page >

┃ A grossly exaggerated fear of structuring lies behind this mistaken position, happily highlighted by the alternative view of one board member ┃

## The Leases Exposure Draft: Is it all it seems ?

By Mark Venus, BNP Paribas, Chair of Leaseurope's Accounting Committee // Continued

IAS 17 currently covers intangible assets, FAS 13 does not, and the new standard will exclude them, although the IASB freely admits that this has no conceptual backing. Would not the pursuit of convergence militate for FASB extending lease accounting to cover leases of intangibles, rather than IASB creating an accounting vacuum in the name of convergence? In a 21st century where software and communications technology are ever more important, is it conceivable that the leasing of intangibles be left aside in a revision of lease accounting?

Even more problematic is the issue of Performance Obligation for lessor accounting. After long debates, the IASB board finally came to realise, and voted, that this accounting big-bang, involving the spontaneous creation of entirely new assets from the meeting of a

lessor and a lessee to sign a contract, was an inappropriate concept. Yet, in order to present unity with a FASB board attached to the idea, a series of last-minute board meetings in the two months preceding the publication of the exposure draft ended with the proposal of a compromise in which Performance Obligation survived. This accounting concept is manifestly inconsistent with the lessee right of use model, has been strongly criticised by experts from and beyond the leasing industry, yet continues to figure in the Exposure Draft by virtue of this poor compromise.

The Performance Obligation debate highlights the difficulty for the boards of coming up with coherent accounting models whilst under the pressure of convergence deadlines. Many other aspects of the project, such as the impairment of underlying assets under Performance Ob-

ligation accounting, the status of right of use assets (tangible or intangible?), and the reality of the simplifications proposed, would benefit from further thought and analysis.

Board members and staff will no doubt present and defend their project as actively as they can in coming months, but could undoubtedly have improved this project had they given themselves sufficient time and resource to consult more extensively and avoid taking decisions on fundamental accounting principles at the eleventh hour.

The comment period certainly gives the opportunity to make these points and others, but will the boards give themselves enough time to consider comments or will they rush headlong towards a self-imposed deadline for publication of a standard?

## Possible Impact of the New Rules in Europe

By Julian Rose, Head of Asset Finance, Finance and Leasing Association (FLA)



By Julian Rose  
Head of Asset Finance  
Finance and Leasing  
Association (FLA)

■ There are some reasons to assume that the proposed new lease accounting rules wouldn't matter a great deal.

The new rules would only apply to users of international accounting standards, a small proportion of European businesses. These are mostly large businesses, listed on the main stock markets, which should be able to cope with new accounting rules. In any case, the IASB and FASB say that for a 'straightforward' lease the accounting would be simple. Investors can already see details of operating leases in the notes to the accounts, so businesses that lease shouldn't worry about any change to their valuations. And there is time for the implications of the new rules on tax, capital

requirements, public procurement and other law and regulation to be addressed.

But there are many questions to ask before we can reliably assess the impact of the proposed new rules.

Perhaps most important is whether the proposed rules will eventually be applied to most European businesses? It is reported that there are 55 different SME accounting codes in operation across Europe. Would some or all of these be changed to reflect the new leases standard?

We also need to consider what would happen if the IASB's own set of SME accounting rules, IFRS for SMEs, was to become widely adopted in Europe. The European Commission's Directorate General for Internal Market and Services is currently considering this. Views in member states vary. The UK's Accounting Standards Board is already consulting over a move from UK standards to IFRS for SMEs for medium-sized businesses, which would take effect by 2015.

If the Commission was to sanction adoption of IFRS for SMEs by national standard setters, we then need to consider how the leases IFRS would be simplified for IFRS for SMEs. And would national accounting regulators further simplify IFRS for SMEs in their own countries?

Larger businesses may, in theory, be well-equipped to cope with new rules. But how many have staff available to take on the extra work that would be needed to follow the proposed rules? Would businesses using leasing recruit extra staff and invest in new systems? Would some businesses just decide that leasing involves too much administration to make it useful?

Just how simple would it be to account for 'straightforward' leases? Would the auditing firms issue guidance on accounting procedures for leases that fit on just a few pages? Would the firms provide simplified procedures for 'straightforward' leases?

Investors shouldn't, in principle, be too bothered by the changes. But would analysts

### Possible Impact of the New Rules in Europe

By Julian Rose, Head of Asset Finance, Finance and Leasing Association // Continued

understand how the new numbers are calculated and what they really mean? Would analysts find the new information more useful than that currently available in the notes to the accounts? How would all of this affect the valuations of businesses that choose to lease?

And is there really sufficient time for the implications of the new rules on tax, capital requirements, public procurement and other law and regulation to be addressed? The UK's tax authority, HMRC, already has to rush through a change to the law by the end of this year. How many

other such changes would be needed across Europe in regulation for tax, capital requirements, public procurement, emissions reporting, and who knows what else? If any of these are missed or inadequately addressed, what would be the consequences be for the leasing market?

So perhaps it could be argued that the proposed new rules wouldn't matter. But how likely is it that the new rules would only apply to the largest European businesses; that those businesses would be willing to incur more costs in reporting their use of leases; that the

auditing firms would ensure that the reporting procedures for so-called 'straightforward' leases were kept simple; that investors would understand the new data for leases; and that all other relevant laws and regulations were changed to reflect the new leases IFRS?

Unfortunately the reality is that the proposed new rules, if implemented, would matter a lot for the European leasing industry and, more importantly, for the tens of millions of European businesses that lease and for the European economy as a whole.

### From DP to ED: Where's the Cost/Benefit?

By Jacqueline Mills, Senior Adviser, Leaseurope



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There are some positive developments that have taken place since the Discussion Paper (DP) phase of the standard setting process took place last year. For example, following efforts from Leaseurope and other leasing associations across the globe, the IASB and FASB have recognised that, if there is to be a consistent

lease accounting model, the accounting from the perspective of both the lessee and lessor need to be taken into account. Lessor accounting now features in the Exposure Draft (ED).

Perhaps the biggest achievement of all is that, although the Boards initially embarked down the path of the performance obligation model for lessor accounting, Leaseurope was instrumental in getting several Board members to acknowledge the many weaknesses of this model. This is one of the main reasons why the draft standard proposes to apply the de-recognition model (to some leases). Without Leaseurope's

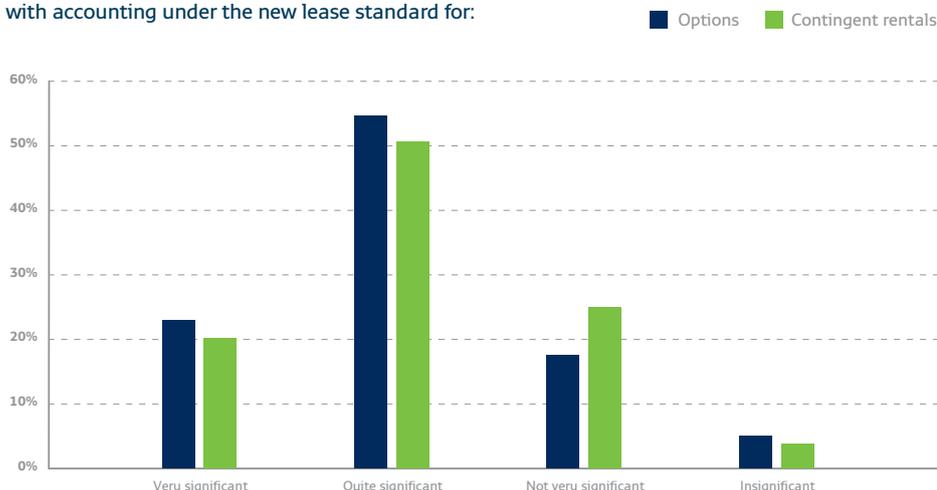
intervention, de-recognition for lessors may not have featured at all in the ED.

On the lessee side, with calls from many of the 300 respondents to the DP (with Leaseurope at the forefront) for the Boards to simplify the proposals, there have been some changes for the better. For instance, purchase options will be accounted for only when they are exercised, whereas the DP treated them in the same, complex way as extension options. Reassessments in preparer's estimates of options and contingent rentals should not necessarily be reviewed at each reporting date and lessors can keep accrual accounting for leases under 12 months.

The issue here is, however, that these changes to what was initially set out in the DP do not represent significant simplifications and, importantly, no real balancing of the benefits and costs of the proposals has taken place so far. They remain unjustifiably complex.

If cost/benefit considerations had effectively been taken into account, it is unlikely that the proposals would still contain the suggested treatment for dealing with extension options and contingent features, which involve sophisticated, probability-based estimates (of which frequent reassessments may still very well be necessary) and can lead to fluctuating assets and liabilities that may often exceed

How do lessees rate the implementation and ongoing complexity and costs associated with accounting under the new lease standard for:



Preliminary feedback from a forthcoming PwC/Erasmus University survey on the impacts of the lease accounting proposals on European lessees. Survey of approx 120 European lessees completed in August 2010

## From DP to ED: Where's the Cost/Benefit?

By Jacqueline Mills, Senior Adviser, Leaseurope // Continued

committed lease payments currently disclosed in the notes. Nor would they have incorporated "IFRIC 4", which is supposed to help preparers distinguish between lease contracts and service contracts but in reality is extremely confusing and difficult to apply. The proposals may also have gone further in terms of providing real relief for lessees of short term leases. Currently, the often referred to "simplification" for lessees just involves the omission of a present value calculation. The bulk of the complex right of use model still applies to these leases. And these are just some examples amongst many of where true simplification could have, but has not yet, been reached.

As they stand, the proposals go way beyond just "putting leases on the balance sheet". The Boards have adopted an approach where there would be an "uncertain overstatement" of assets and liabilities (because amounts greater than committed lease payments will often be capitalised), which, they argue, is preferable to a "certain understatement" in the accounts of lessees. Even if that is true, it should be weighted against the costs for lessees who will have to apply the rules to tens of thousands of small-ticket leases and rentals as well as to the few big-ticket contracts at the core of the debate. Recently, it has been said by one Board member that it is not easy to understand why a change in accounting would cause people to change their views about the benefits of leasing. The issue that many stakeholders, including Leaseurope, have is that the Boards have not been looking for any concrete evidence to either confirm or refute this statement. While Leaseurope will do what it can to provide solid, impartial evidence to support its claims, surely the burden of proof of whether or not the benefits of the proposals exceed its costs should lie on the body proposing the new treatment, and not those who will have to apply it?

As pointed out above, it is positive that the Boards' are dealing with lessor accounting, but the hybrid model proposed in the ED makes little sense. It is a well known fact that standard setters want to remove existing lease classification. Yet, this is effectively what the lessor proposals will involve: two models, based on a dividing line that is similar to the existing

finance/operating lease distinction (with the ED setting out highly subjective and inoperable criteria for making this distinction). There is no convincing justification in the ED as to why lessors have different types of leases requiring different models whereas lessees do not.

The Boards also have yet to come up with a compelling argument for why the performance obligation model is consistent with their proposals for lessee accounting. This starts to get technical, but basically goes back to the old "executory contract" debate that many lessors are familiar with. Lessors cannot be viewed as having performed when accounting from the perspective of the lessee is considered and simultaneously still having a performance obligation when it is lessor accounting that is being looked at. Either the lessor has performed on day one of the lease, making the contract a non-executory contract, or it has not. If the lessor has not performed as the performance obligation model implies, lessees should not be capitalising leases. This is why only the derecognition model for lessors is consistent with a right of use model for lessees.

Had the Boards dealt jointly with lessee and lessor accounting from the start of their project, it is unlikely that this situation would ever have arisen. If more time had been taken before the ED was issued, the Boards may very well also have arrived at the (natural, we would argue) conclusion that their overall model is currently inconsistent. It is unfortunate therefore that the ED contains an approach that has not thoroughly been thought out. This situation confirms that an additional Discussion Paper, covering both accounting for lessees and lessors together, as called for by Leaseurope, would have been an extremely beneficial addition to the project and helpful in achieving a high quality final standard.

The comment period to the ED, due to last until 15 December of this year, is an important opportunity for those with concerns on the proposals to react. It will be used by Leaseurope to ensure that i) the lessor accounting proposals are significantly improved, ii) that both lessee and lessor accounting are truly simplified (cost/benefit considerations will be covered

extensively in our response) and iii) that the overall model is consistent. The Federation is committed to assisting the IASB in achieving its goal of improved financial reporting for leases but those three overarching issues will have to be resolved before this can be considered to be the case.

We will also point out that a very different approach could have been adopted right from the start of the process. While existing guidance for leases is often criticised, no attempt has been made by the IASB to analyse the extent and nature of the use of leases by preparers reporting under IFRS. Let's not forget that a significant number of leases in Europe are finance leases. Of those that happen to be operating leases, the vast majority are straightforward leases for small items. These are very far removed from the big ticket or structured leases that are the focus of standard setters' concerns. Basing the creation of a new model for lease accounting on the premise that companies use leasing solely as a structuring tool is wrong and has resulted in a draft standard that is not appropriate for the vast majority of firms who choose to lease as it is an effective and flexible solution for obtaining the use of an asset without in many cases bearing the asset's risk.

In other words, many businesses, including the leasing industry, feel that the case for change still has to be made. The logical place to start the standard setting process would have been to carry out a full analysis of "problem areas". Only then would it have been possible to demonstrate that today's model is effectively broken, and it should have been on that basis that a new standard was designed.

### Consult Leaseurope's prior positions on the lease accounting project:

- Leaseurope's [response](#) to the March 2009 Discussion Paper
- Leaseurope's [comment letter](#) to the IASB/FASB on lessor accounting (January 2010)

### Dates to remember in the lease accounting project

2010	2011	?
Dec	end	
15	Q2	tbd
Comment period to the ED closes	Leases standard to be finalised	Effective date of the standard

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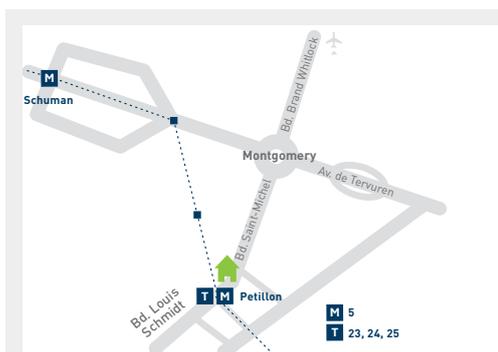
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