Leaseurope Briefing
June 2012

Changes to International Accounting Standards for Leasing & Rental: Impacts on the European Economy

---

Leasing in Europe

In 2011, European leasing companies represented through the member associations of Leaseurope granted new leasing volumes worth approximately EUR 224 billion[1]. These leases were used by European businesses to gain access to many different types of productive assets, including plant and machinery, ITC and office equipment, medical devices, renewable energy infrastructure, vehicles and other transportation equipment as well as property. Of the total new leases granted in 2011, almost 90% were granted to finance various types of equipment and vehicles.

Depending on the individual European country, between 20-30% of business equipment investment is supported by leasing[2]. Over 50% of all leasing to businesses in Europe is made to micro, small and medium enterprises (SMEs) and an estimated 40% of all European SMEs used leasing in 2010, which is more than any individual form of bank lending. In particular, leasing was used more than bank loans over 3 years (38%) and overdrafts (37%)[3].

These figures demonstrate the considerable contribution leasing makes to the European economy by providing businesses, and SMEs in particular, with a means to support their investment needs.

Why do businesses lease or rent?

Leasing and rental products are easy to set up and offer a broad set of benefits to a wide range of businesses. These include the possibility for a company to obtain the use of an asset without having to provide additional guarantees or collateral (as would typically be the case should they take out a bank loan), use assets in a flexible manner without bearing the risks associated with ownership, manage working capital efficiently and simplify budgeting exercises. Additionally, leasing and rental products often include a range of associated services (such as insurance and maintenance) that effectively allow the user to outsource all of its asset-related needs to the lessor. Lease and rental contracts can be acquired at the point of sale of a manufacturer or dealer from which a client wishes to obtain the use of asset. Leasing therefore provides a one-stop-shop for accessing equipment. This represents a clear advantage and convenience for the customer compared to loan finance as this often has to be arranged through a bank separately to the asset purchase. Additionally, this helps support the sales of equipment and European manufacturers and dealers consider leasing to be essential to their business in this respect.

---

[1] Leaseurope 2011 Annual Survey of the European Leasing Market
[2] Due to a lack of more detailed breakdowns of investment figures published by official European sources, we are not able to specifically calculate the penetration rate of leasing to the private sector at European level. Depending on the individual country, the figure tends to be in the range of 20% - 30% of total private sector equipment investment.
[3] Source: "The Use of Leasing Amongst European SMEs" by Oxford Economics (Nov 2011). Please visit the SME report page on Leaseurope's website for more details on this publication

Changes to international lease accounting

International accounting standard setters, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), are currently considering joint proposals that will fundamentally change the way businesses account for their leases and rentals of property and equipment. The project forms part of the IASB and FASB's Memorandum of Understanding. An exposure draft (ED) standard was issued for public comment in 2010. The Boards received around 800 comment letters in response to this consultation and have since been re-deliberating their initial proposals. The next step in the Boards' due process will be to issue another, revised ED for public comment, possibly in the fourth quarter of 2012.

Existing lease accounting approach

Under the existing International Financial Reporting Standard (IFRS) for leases (IAS17), businesses account for leases and rentals either as finance leases or operating leases. With a finance lease, the lessor is deemed to have transferred most of the risks and rewards relating to ownership of the leased asset to the lessee. The leased asset is thus shown on the balance sheet of the lessee in a similar way to assets it owns outright. With an operating lease, the lessor is considered to have retained these risks and rewards and therefore keeps the leased asset on its balance sheet. The lessee treats rental payments as expenses and provides details on its committed payments and lease arrangements in the notes of its accounts.

Future approach to lease accounting

Under the proposed model for lease accounting, a lessee will always have to recognise an asset, the right to use the leased item, along with a corresponding liability on its balance sheet. This approach is referred to as the right of use model.

Is there a need to change today's lease accounting standard?

The existing lease accounting model has been criticised by standard setters because lessees do not recognise liabilities under operating leases. They argue that this leads to users of accounts having to make adjustments to the financial statements in certain cases and can result in similar contracts being portrayed differently.

However, in our opinion, the standard setters have not sufficiently understood and analysed the extent and nature of the use of leases by preparers reporting under IFRS. A significant number of leases in Europe are finance leases. Of those that are operating leases, the vast majority are straightforward leases for small items such as cars, copiers, IT, telecom equipment and other low value items. Each year European lessors grant millions of new leases, with the average deal size being around €20 000 to €30 000[4]. These are very far removed from the big ticket or structured leases of property or aircraft that have been 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 as standard setters have been doing is wrong and will result in a standard that will not be 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 asset risk.

[4] Leaseurope Ranking Survey of European Lessors

It is also important to note that European businesses apply the principles of the current accounting model correctly. When standard setters refer to "structuring", they are referring to the existence of bright line rules (i.e. quantitative tests and thresholds) that exist only in the current US leasing standard. European preparers have to apply IFRS which requires them to consider their leases using a "substance over form" approach. They therefore cannot justify keeping a lease off the balance sheet if they do in fact bear the risks and rewards associated with the leased item.

Impacts of the new approach for lessees

- Businesses that lease will see an increase in their leverage under the new proposals, associated KPIs may be affected and debt covenants may be triggered as a result.
- The measurement of the new assets and liabilities created under the right of use model could result in an upfront increase in costs for lessees who will appear to be less profitable than today for no other reason than accounting treatment.
- Firms will be faced with complex judgement calls when determining whether they have a lease contract or a service contract.
- Companies who make use of lease documentation to effectively outsource asset related needs will be faced with managing asset registers and accounting for these assets. Even the simple aspects of accounting for rights of use assets will be problematic for these entities as they will have chosen to lease because they are able to account for these contracts today as straightforward operating expenses.
- Businesses will have to analyse the service components that are part of lease contracts. Currently, one of the major benefits of a lease is that lessees do not have to consider such aspects. Instead they receive a single invoice encompassing all the costs related to the use of the asset.
- Whilst firms may be able to manage some of the complexities noted above at the level of a single lease contract, a much more significant form of complexity arises in the organisational process required in entities to collate, verify, assemble and present reporting on the many small ticket leases that are managed in varying locations around the company.
- Banks are an important category of users of leasing. For instance, many of them lease the premises of their banking branch networks or headquarters. These businesses may see increases in their regulatory capital unless regulators clarify that right of use assets warrant specific risk weighting treatment because they have a different risk profile to other types of assets (such as intangibles).

Effects of the new proposals on the European economy

The most significant cause for concern with the new proposals is the level of complexity they will create for lessees (see above). It should be noted that no firm will be immune to this complexity as almost every European business leases or rents property or equipment at some point in time. Moreover, although firms with high value leases will also experience these negative effects, paradoxically it will be those companies who have many small ticket leases, very far removed from the structured, high value transactions that are at the core of the leases debate, who will be the hardest hit. Examples of these types of contracts include car contract hire, office, IT and telecom equipment rentals and facility management contracts, to name but a few. Given the additional burdens that will created for businesses with the new proposals, some entities may no longer find leasing to be an attractive proposition and/or will experience a general increase in costs due to the significant changes in IT systems and internal processes and controls that will be engendered by the new proposals. These costs will ultimately be passed on to the final consumer.

And while EU law requires that IFRS standards apply only to listed companies, more and more Member States are basing their national accounting systems on these principles. It is simply a matter of time before Europe's SMEs will be required to apply the concepts of a new lease accounting standard and this additional burden could have a significant effect on their use of leasing. Ultimately, the public sector could also be affected.

If the proposals have the effect of limiting leasing as Leaseurope expects they may, smaller firms in particular could have a much harder time gaining access to productive assets. These are firms with limited sources of external funding to begin with. They therefore rely heavily on leasing to support their investment and, without the benefit of the collateral that leasing naturally incorporates, their borrowing will become more costly and/or more difficult to obtain. Of course, this is also true for larger firms, although corporates typically have more options available to them.

Nevertheless, we are very concerned that European investment, and thus European growth, will suffer as a consequence of this project.

A lengthy debate and a wide variety of views

The debate of the past few years clearly shows that different stakeholders have different views on how to account for "leases". In particular, different users of accounts have different needs. For instance, there are those who support the right of use model as proposed in the 2010 ED because their focus is on expected cash flows. These users would presumably like to see all contractual commitments (e.g. for service contracts such as electricity, phones or even employees) portrayed on a company's balance sheet. Then there are those who consider that a part of the population of transactions referred to as leases are equivalent to financing a purchase and therefore support the ED model, but only for these specific contracts. There are also users who support the existing model (IAS 17) because they consider that it appropriately reflects the difference between securing the long term availability of an asset and having flexible access to assets without bearing asset related risk. Lastly, there are those who would like to see some combination of the information available under all of those approaches or yet others still.

As a result, it is extremely difficult to design a standard that adequately addresses the needs and concerns of all parties. A single balance sheet number is unlikely to ever provide sufficient information for a wide variety of stakeholders.

It has also become apparent that stakeholders do not always refer to the same concept when using the term "lease". Many do not view outsourcing contracts that enable a client to acquire a service from a provider that takes care of all the asset-related needs involved in this service as being leases. In Europe, many do not consider "rental contracts" to be leases but see them as a form of hire, or in the other words the provision of a non-financial service. This means that feedback the Boards receive needs to be interpreted with care and according to the constituent's understanding of what leasing actually is.

An alternative way forward

Consequently, we are of the view that the most efficient and realistic option for moving forward with the project at this stage is to recognise that there are different types of contracts that fall under the current notion of leases, with one of these categories being services (or executory contracts in accounting jargon).

We therefore strongly recommend that the Boards retain the concepts of IAS17, ensuring a principles rather than rules-based application of these concepts and they work to improve disclosure requirements for leasing. We note that this is very similar to the view presented to the IASB by EFRAG during their joint March 2012 meeting[5].

Conclusion and action points

There is a very real danger that any new lease accounting standard will be so complex that it overshadows the economic benefits of leasing products. Equally, it may fail to meet the wide variety of needs that users of accounts have and may very well not represent a sufficient improvement on existing account to warrant the costs of change.

In the current economic climate, where many European businesses are struggling to find financing, be competitive and grow, it is particularly important that sufficient attention be dedicated to this matter at EU level.

European decision makers must ensure that international accounting standard setters are held accountable and that they conduct a comprehensive cost/benefit analysis of their proposals before producing a final standard, in line with the European Commission's call for a "full effects analysis to be developed as soon as possible in the life-cycle of a project"[6]. Any new lease accounting model must be designed to address proven weaknesses of the existing model effectively and proportionately, while avoiding potential detrimental effects to the many users of this product.

Leaseurope would suggest that this can be done by for instance by harmonising definitions between US standards and IFRS by removing US GAAP bright lines and considering improvements to the disclosures that are currently required.

Leaseurope recommends that European policy makers and business representative ensure they are fully aware of the implications of the proposals and take the opportunity of the publication of the IASB/FASB's new exposure draft standard in the fourth quarter of the year to have their views taken into account in a final standard.

For more information, please visit Leaseurope's website www.leaseurope.org or contact Jacqueline Mills, Director of Asset Finance and Research, Leaseurope, at j.mills@leaseurope.org or +32 2 778 0566

[5] Joint IASB/EFRAG meeting of 9 March 2012. See summary of main messages expressed by EFRAG delegation here.
[6] European Commission's Contribution to the IASCF Constitution Review, 22 June 2009