The Voice of Leasing and Automotive Rental in Europe

Open Letter to the International Accounting Standards Board on the Accounting for Leases

October 2012

Background

The IASB and FASB (the Boards) have been working to develop a new accounting standard for lease and rental contracts since 2006. After several rounds of consultation which have generated massive response from constituents all around the world, the Boards are due to issue revised proposals for public comment in the first quarter of next year. This new proposal is likely to require businesses who lease to capitalise all leasing and rental contracts, with a categorisation of leases that would result in the different treatment of equipment and real estate leases.

Leaseurope, the trade association representing the European leasing and automotive rental industry, has been participating in the review process of international lease accounting since its start. Throughout this process, we have maintained that the existing IFRS standard for leases, IAS 17, when applied correctly, recognises the assets and liabilities that occur under leases appropriately and reflects the economics of different types of leases. Nevertheless, we have supported the Boards in their efforts to develop a new model to the best of our abilities, notably by offering technical comment on the various versions of the proposals, analysing their potential impacts on businesses and by providing alternative, pragmatic solutions to the accounting for leases.

We have consistently attempted to describe the realities of the leasing business in Europe and have pointed out on numerous occasions that this reality is far removed from the business of big ticket leasing or structured leases of property or aircraft that has often been depicted by standard setters.

We consider it useful to briefly recall the facts about leasing in Europe:

- In 2011, European leasing companies represented through the member associations of Leaseurope granted new leasing volumes worth approximately €224 billion[1].
- Depending on the individual European country, between 20-30% of business equipment investment is supported by leasing[2].

[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.

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- 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. Leases are 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 equipment, vehicles and other means of transport as well as logistics equipment. Of the total new leases granted in 2011, almost 90% were granted to finance the use of various types of equipment and vehicles.
- A significant number of leases in Europe qualify as IAS17 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[3].
- According to a Leaseurope survey of pan-European leasing companies[4], just over 70% in value and 93% by number of operating lease contracts granted by the firms in this sample in 2011 were for small ticket assets worth less than €50 000. In terms of number of contracts, 63% of these operating leases were for assets under €20 000.

Taking stock

After 6 years of re-deliberations, we consider that the proposals due to be re-exposed are not an improvement over the existing leases standard and do not warrant the cost and burden of change.

While much has been learnt about leases during the course of this project, many stakeholders are increasingly of the view that the Boards have still not found a better solution. These stakeholders consider that the current accounting standard is actually one of the best ways to meet the wide variety of user needs with respect to leases, particularly if it were to be accompanied by more detailed disclosures on these contracts. The European leasing industry shares this view.

In our opinion, the difficulty in finding a panacea for accounting for leases lies in the fact that different users of account clearly have different views what “leases” actually are and how they should be accounted for:

- For instance, there are users who support the right of use model as first proposed by the Boards because their focus is on expected cash flows. These users would probably like to see all executory (service) contracts (and not just lease and rental contracts) portrayed in the same way.
- There are other users who support the so-called “whole asset model” because their focus is on ascertaining an entity’s return on assets employed.
- Moreover, there are users who consider that some of the contracts currently called leases are equivalent to financing a purchase and therefore support straight line depreciation of the asset that results from the lease contract in such circumstances, accepting that this implies cost acceleration in the P&L for those specific contracts.

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[3] Leaseurope Ranking Survey of European Lessors

[4] European Operating Lease Data – 2011; a Leaseurope survey of 8 major pan-European lessors representing approx. 20% of the European leasing market.

- There are yet other users who support the existing accounting model for leases (IAS 17) because they consider that there is a difference between securing the long term availability of an asset and having flexible access to assets without bearing asset related risk. Those users who want to look at the break-up value of a firm presumably also support this existing model.
- Lastly, there are of course those who would ideally like to see some combination, or all, of the information available under all of those approaches.

During the consultation process, it has also become apparent that users of accounts and other constituents are not always referring to the same concept when using the term “lease”. Many do not view contracts that use lease documentation to enable a form of outsourcing where a client acquires a service from a provider that takes care of its asset-related needs as being leases. Many do not consider rentals to be leases.

The wide variety of analysis perspectives, informational needs and fundamentally different ways of viewing lease contracts that prevail amongst stakeholders have made this project extremely complicated. As a consequence, the Boards have struggled to produce a conceptually sound model that is capable of meeting such a wide range of needs, especially if this is to be achieved through the provision of a single number presented on the face of a lessee’s balance sheet.

Leaseurope views

While the existing model has been criticised by the Boards, we think that these concerns have been greatly overstated. The “flaws” of existing lease accounting stem mainly from the reference in the US lease accounting standard to bright line rules (i.e. quantitative tests and thresholds). IAS 17, the international leases standard applied in Europe, does not have such bright lines but instead adopts a substance over form approach to lease accounting. It is based on a number of sound principles that appropriately distinguish between two very different sets of economic transactions. Contrary to US preparers, European preparers using IAS 17 cannot justify keeping a lease off their balance sheet if they do in fact bear the risks and rewards associated with the leased item.

We would argue that the debate of the past years has revealed there is in fact no single magic number that best reflects an entity’s use of leasing and rental, nor is there an approach to lease accounting that is superior to the existing approach in all circumstances. In our view, in such a situation the interest of users and preparers of accounts may very well best be served by the provision of additional disclosures around the existing model. We note that this view is very similar to that presented to the IASB by EFRAG during their joint March 2012 meeting[5] and that it would be supported by many European (and international) constituents.

[5] Joint IASB/EFRAG meeting of 9 March 2012 - Summary of main messages expressed by EFRAG delegation

There are numerous advantages to an approach retaining a principles-based categorisation of leases with increased disclosures. First of all, by retaining a theoretical framework that is well understood, complemented with additional breakdowns of committed payments under operating leases, users would have the necessary information and flexibility to gain a full understanding of an entity's use of leasing and determine the metrics they consider to be the most useful in their analysis of a company. Secondly, the cost of change for users and preparers has been cited as one of the major difficulties with the Boards' proposals. These costs would be much more limited under an approach that aims to improve lease disclosures without overhauling completely the conceptual framework for these contracts. Additionally, other longer-term, economic impacts of the change that have not yet been analysed by the Boards would also be kept to a minimum. These include for instance consequences on the accounting for SMEs and national accounts that could affect European business investment but also unintended consequences that may arise due to the link of European tax and financial legislation to the existing framework for lease accounting.

Conclusion

After several years of pro-active and constructive participation in the project, Leaseurope has come to the firm conclusion that the Boards need to take a step back from the details of their current draft standard and reflect on where things stand. We are of the opinion that the most efficient way forward in the leases project is to harmonise definitions between US and IFRS leasing standards by removing US GAAP bright lines and introduce improvements to the disclosures that are currently required.

The European leasing industry is ready to assist in this process and urges the Boards to take these views into account before releasing another document for public consultation.

We remain at your disposal and please do not hesitate to contact us or Leaseurope staff (Jacqueline Mills, j.mills@leaseurope.org - +32 2 778 05 66) for any further information you may require.

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