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ISSUES RAISED BY THE JOINT IASB/FASB LEASING PROJECT

1. Leasing representative bodies around the world - the UK Finance and Leasing Association, Leaseurope, the US Equipment Leasing and Finance Association, the British Vehicle Rental and Leasing Association, the Australian Equipment Lessors Association and the Canadian Finance & Leasing Association - would like to play a full, active and constructive part in the development of the long term leasing project jointly agreed by the International Accounting Standards Board (IASB) the Financial Accounting Standards Board (FASB), respectively the Boards (the "Boards") on 19 July 2006.

2. In the light of the Boards' work to date, including the convening of the IASB Working Group on February 15 and the subsequent ASB/FLA Conference on Equipment Leasing Standards, we want to address key principles identified at this stage that we hope the Boards will address as they proceed with deliberations. As the project continues, we would expect other issues to arise. We are not at this time attempting to suggest any answers or solutions to these issues, but rather to add them to the discussion. As the process moves forward, we would welcome the opportunity to consult with and meet the Boards to develop such solutions as well as explain market lease terms and structures which will be critical to the development of the proposed new leasing standards. We hope that this is the beginning of what will be a constructive dialogue which will help the final outcome work for all interested parties. We also appreciate that the projects on the conceptual framework and revenue recognition are under way at the same time and, inevitably, will impact on the leasing project, as it will on them.

Leasing Representative Bodies

3. The FLA is the principal representative of the asset, consumer and motor finance sector in the UK. FLA members £93.0 billion of new business in 2006. Of this £27.5 billion was provided to the business sector and UK public services, representing 30% of all fixed capital investment in the UK in 2006 (excluding real property). The remaining £65.5 billion was provided to the consumer sector, which included 28.8% of all unsecured lending in the UK. Included in this is £18.4 billion of finance provided to the motor sector. FLA members financed at least 50% of all new car registrations in the UK in 2005.

4. The Equipment Leasing and Finance Association (ELFA) is the trade association representing financial services companies and manufacturers engaged in financing the utilization and investment of/in capital goods. ELFA members are the driving force behind the growth in the commercial

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equipment finance market and contribute to capital formation in the U.S. and abroad. Its over 750 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packagers and investment banks, as well as service providers.

5. Leaseurope, the European Federation of Leasing Company Associations, is the umbrella body of both the leasing and automotive rental industries in Europe. The Federation is composed of 48 Member Associations in 34 countries. Leaseurope's 2005 annual statistical enquiry revealed that the new leasing business of its leasing member associations was estimated to be around 270 billion euros, making its market the largest leasing market in the world. The leasing companies represented via Leaseurope's members account for more than 90% of all European leasing. In addition to these 1,300 leasing companies, Leaseurope's membership also includes around 7,200 automotive long and short term rental companies.

6. The British Vehicle Rental and Leasing Association (BVRLA) is the trade body representing organisations providing short term rental and full service operational leasing of cars, vans and heavy goods vehicles in the UK. Its circa 800 Members represent over 95% of the sector, by vehicle volume, and span from the larger multi national rental operators, bank owned full service leasing companies through to SME operators in all three sectors. The total number of vehicles operated by BVRLA members is in excess of 2,300,000 with circa 42% of all new cars, 30% of vans and 25% of heavy goods vehicles being purchased by the BVRLA members on behalf of their customers.

7. The Australian Equipment Lessors Association (AELA) is the association representing the equipment finance industry. AELA's 100 member companies, including banks, independent finance companies and manufacturers, represent more than 90% of the A$30 billion annual equipment financing.

8. The Canadian Finance & Leasing Association (CFLA) represents the asset-based financing, equipment and vehicle leasing industry in Canada. With over $92.3 billion of financing in place with Canadian businesses and consumers, the asset-based financing industry is the largest provider of debt financing in this country after the traditional lenders (banks and credit unions).

Introduction

9. This paper covers the conceptual issues that we all believe must be discussed and settled during the leasing project. There are of course a myriad of accounting and related regulatory issues that arise at national level,

because of different markets, product ranges and laws. We will communicate with the standard setters as individual associations on these.

10. Our paper has been in development for a while, and has been updated to take account of the papers prepared by IASB/FASB staff for the leasing advisory group on 15 February (which formed the basis of the Board's first preliminary discussion, in revised form), and the joint UK Accounting Standards Board /FLA conference held on 26 February.

Overall approach

11. We are aware that the "right-of-use approach" as set out in the papers published by IASB/FASB staff for the leasing project working group and the G4+1 group has been broadly favoured by the Board and standard setters in the recent past. However, we have a number of concerns about the practicalities of applying a full components approach to all lease transactions, regardless of materiality. Indeed, we strongly believe that whatever the approach adopted it must be implemented in such a way that it is practicable to apply and results in useful information to the users of accounts. Consequently, we welcome that the two Boards have indicated that they intend to look at the leasing project afresh and would be glad to discuss alternative approaches if the IASB/FASB wish to do so. While there must be an approach that is technically sound and consistent with the IASB/FASB Standards, we also seek a leasing standard which is realistic and workable for our industry and its customers, for lessors and lessees. So in this note we seek to identify more detailed issues which need to be addressed to achieve such a standard. We believe that they raise a number of key questions that go deeper and wider than those posed in the 15 February staff papers. Though we recognise that the staff plans to return to some issues, such as scope, not covered in those papers, we think it is worth detailing our concerns, which go wider still.

12. Our Members are very keen to have a single, efficient global leasing standard. The more similar that the two standards finally adopted by the IASB and FASB are, the better, in our strongly held view. Ideally therefore, and in light of momentum towards convergence, we would like the Boards to adopt the same standard. We are conscious, however, that under EU law the EU can accept or reject IFRS individual standards. IAS39 also seemed to undergo amendment during this process, though the relevant legislation does not allow for that explicitly. In the circumstances we hope that the IASB will involve the EU at a sufficiently early stage to minimise the risks of the IAS standard diverging from the FASB one at a late stage.

13. In our view, any new standard on leasing should start by understanding the information needs of shareholders, business and credit analysts and other

users of accounts, and the impact of leasing (considering the various types of leases, from short term equipment leases to long term real estate leases) on a company's accounts. In practice, it is unlikely that any one balance sheet number will adequately capture all the facets of information that an analyst or other user of the accounts would reasonably need. The right-of-use approach, the whole asset approach, the risks and rewards approach and the executory contract model all provide different useful dimensions of information, but none by themselves provide a complete picture of the impact of leasing on a business. Furthermore, regardless of the approach chosen, there is always the need for appropriate disclosures to be made in the notes of the financial statements to complement the information available in the balance sheet and P&L. We therefore believe that the focus should be on providing the best practical solution that provides the most useful information at a reasonable economic cost rather than perhaps seeking a purely conceptual solution.

14. The new leasing standard should also be focussed on those parts of the market where the existing standard is least useful: proportionality should be a key theme. Standard setters have already made it clear that materiality will be significant, though a debate will be needed on what is material. The new standard should also not impose unreasonable burdens on SME lessees, where their external finances are relatively straightforward and the investment community has little interest in the role that leasing plays. Nor should the new standard make accounting unnecessarily complex for high volume, low value transactions, such as are common in the office equipment market. Large property transactions, in many economies, dominate the high value, structured, long term leasing market, and this needs to be borne in mind when constructing a new standard – though there too the standard should be sensitive both to technical and market needs for financial statement information, just as it should be for high value equipment leasing. In the US it is estimated by ELFA that real estate leases account for more than 70% of footnoted future operating lease payments. Similarly, studies based on data for UK listed firms show that in certain sectors, over 97% of identified operating leases are leases of "land and buildings"[1].

15. We believe that at the outset of the project it is vital to be clear about the scope of it. We would expect that the new standard would need to look very carefully at the definition of a lease and the possible overlap with executory service contracts. The existing guidance, contained in IFRIC 4, while relatively new, will need to be re-examined in the context of any new methodology. For example, under existing standards, it is clearly important to distinguish between an executory contract and what is currently a finance lease but it is less important to distinguish between an executory contract and

[1] Goodacre, A. (2001), "The potential impact of enforced lease capitalisation in the UK retail sector", *University of Stirling, Department of Accounting, Finance & Law*, *Discussion Paper No. 01/01*

what is currently an operating lease. If all leases are brought on to the balance sheet of lessees, the latter distinction will be far more significant and clearer and more detailed guidance will be necessary as to where this bright line lies.

16. A number of current lease structures would, in our view, fall within the "executory" type category – having the nature and substance of such contracts. The lessee's obligation to pay rentals does not become unconditional when the asset is delivered. The obligation to pay rentals may still be conditional; for example, upon the asset being properly serviced (by the lessor) and meeting performance criteria. This can only be assessed by the lessee at the time its current rental is due for payment. At a minimum, we would consider it appropriate that the IASB/FASB investigate the extent to which leases meet the characteristics typical of an executory arrangement to ensure that the related accounting is appropriate. We believe that executory contracts i.e. full service contracts should be outside the scope of the leasing standard. Indeed it would have been preferable if standard setters had first examined accounting for executory contracts in general, with leases being treated as a subset. We feel there should be a broader scope to include full service leases, service contracts and outsourcing contracts.

17. While the focus of technical comment is on the balance sheet of lessees, the "revenue recognition" project will be of importance to lessors.

Basic principles

18. There are some basic principles which the industry believes a new standard must meet:

    i. It must provide information about future lease obligations and rights to use assets that are both meaningful and useful to the users of accounts. For example, it should give real information about future committed cash flows and the flexibility and conditionality of those cash flows.

    ii. The standard needs to recognise that there are real economic differences between leases and loans, and indeed other financial instruments, and should distinguish leases from debt, other types of obligation and other types of executory commitments. There are real economic differences among different kinds of lease as well.

    iii. It should recognise that the rights and obligations of the lessee and lessor vary not only from contract to contract, but also by jurisdiction, and in some cases between the private and public sectors. An international standard must therefore be sufficiently robust and flexible to work under a variety of different legal frameworks. In some legal frameworks the lease rents are not obligations in bankruptcy. In the right-to-use approach, at what point would the lease obligations be derecognised when the lessee's credit is deteriorating? Where the lessee's obligation is unconditional only to the extent that its particular credit rating is maintained, we would suggest that the existence of such a provision mean that the arrangement is executory.

iv. It needs to recognise that the range of assets and contractual arrangements between lessee and lessor and the flexibility for the lessee to cancel, extend or modify these arrangements varies enormously. As noted above, different jurisdictions may also treat lease options or modifications differently. It is important for the accounting principles to treat the different legal effects differently.

v. It needs to have very clear and unambiguous definitions of leased assets and obligations and the basis of their measurement. Regarding options, valuing and recording options at lease inception, although a sound theoretical concept, will be difficult, if not impossible, to measure in a meaningful way in the absence of quoted prices in active markets or reliable valuation techniques.

vi. Lessor and lessee accounting must both be covered comprehensively. Lessor accounting raises complex issues which should be fully and properly debated and not simply considered the mirror image of the lessee's accounting.

vii. Lessor accounting should take account of the economic consequences of material tax benefits and the time value of money in the measurement of leased assets and the recognition of income.

viii. Simplicity in lessee accounting, whether tax based or not, is important so that otherwise sound economic transactions are not avoided because of cost benefit considerations.

ix. The new standard must define how to account for immaterial leases. Presumably they will be accounted for in a similar fashion as the current operating lease method.

In such cases, more robust disclosure may be useful, including explaining leasing policies for classes of assets, disclosing expected actions at lease expiry, disclosing calculations that the analysts need like the present value of lease payments using the unique incremental borrowing rate for each lease, disclosing the weighted average incremental borrowing rate of leases combined and the expected future rent expense to be paid for immaterial leases of core equipment.

x. Taking account of the IASB project on a set of standards for SMEs, the new standard should have a modular structure, with varying degrees of information and complexity required, in relation to the kind of lease transaction and lessee. Care should be taken as regards leases of "commodity" items e.g. cars, photocopiers and the like, where arrangements are akin to executory arrangements. The new standard should treat both large ticket transactions and small ticket items appropriately, which does not necessarily mean identically.

xi. The new standard should clearly distinguish leased and owned assets in the financial statements of the lessee.

xii. The standard should consider carefully the P&L implications of a changed treatment of lease payments. Clearly, the annual payments associated with an operating lease with no purchase option correspond to the cost of using the leased asset. Therefore, any capitalisation of the lease should not alter the P&L result, particularly as the strict link between P&L results and tax treatment in many countries means that this aspect could have a significant impact on many businesses. In other words, lessee accounting for the periodic expense in a capitalised lease should be on a straight line basis reflecting the economic costs of the temporary right to use an asset, rather than straight line depreciation and imputed interest expense which are more appropriate for an owned asset funded with debt.

xiii. Whilst appreciating that the key focus of any new standard will be on the basis on which leases are recognised on the balance sheets of lessees, it is important that the basis on which leases are measured in the balance sheets of lessors is also adequately considered. This is of particular concern to a number of European countries' lessors as the current methods used for income recognition under IAS 17 - namely the net investment approach for finance leases and, in most cases, straight line rental recognition and straight line depreciation of the asset for operating leases - result in carrying amounts that do not reflect the economic value of the transaction undertaken. Consequently, under the present standard, profitable deals are often presented as loss-making in the early years though their underlying economics are sound. Similarly, in some cases, excessive profits can be recognised in the early years of a lease followed by subsequent losses. Neither of these provides meaningful information to the reader of the accounts as to the financial position of the entity and also inappropriate accounting results in inappropriate commercial decisions being made.

19. The proposed changes as discussed to date are dramatically different from the status quo and could well have a very significant impact upon the leasing industry world-wide as well as on the businesses that use leasing for finance purposes globally. This impact could be positive. But leasing's attractions for companies and public entities might well fall, threatening capital investment programmes that leasing has historically funded. It is important therefore, that any new standard is widely accepted as being wholly appropriate, reflecting not only the need to provide clarity to "non technical" users of accounts, but also reflecting the commercial substance of transactions. It should not be assumed too lightly that other sources of capital would replace leasing in sufficient quantities if the accounting changes have adverse commercial effects.

20. By the same token, it is worth singling out the role of leasing in the developing world. Both in the post-Soviet economies and in Latin America, Asia and Africa leasing is a very useful financial tool for providing the new investment so vital to these economies' futures. The IFC and the EBRD have both emphasised this positive role.

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