The Voice of Leasing and Automotive Rental in Europe

The Review of International Lessee Accounting

The European Leasing Industry's Preliminary Views on the Direction of the Joint IASB/FASB Leases Project

Executive Summary

- The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are currently in the process of developing **a new standard for lease accounting**. A Discussion Paper, setting out the IASB's initial views on the direction the new standard for leases will take, is expected in the first quarter of 2009.

- The new approach, often referred to as the **right of use approach**, differs substantially from today's standard which is based on an analysis of the risks and rewards inherent in the lease. Under the right of use model, **a lessee would always recognise an asset**, the right to use the leased item, and a corresponding liability on its balance sheet, whereas under the current standard, a lessee recognises the leased asset only under so-called finance leases.

- With users of financial statements **already making adjustments** to take into account uncapitalised lease payments, on this basis it is unlikely that the new approach will make a significant difference to these users' assessments of a lessee's financial position.

- However, lessees should be aware, that with more assets on their balance sheets, they may be required to **hold additional capital**. Particularly in the current economic environment, this may have a significant impact on business activities.

- The review implies several additional changes to "simply" requiring more assets on the balance sheet. The inevitable diversity of approaches that may be adopted by lessees under the new approach may well result in accounts that are **less understandable and comparable** than today.

- Moreover, the single most important concern of the European leasing industry is that a new standard will be **unnecessarily complex.** Its costs are likely to be disproportionate to the gains for the users of accounts and it may very well obscure the true economic benefits that leasing offers. Indeed, leases are entered into for a variety of valid economic reasons, regardless of financial statement presentation**.**

- Furthermore, it is important to note that the majority of leases are **plain vanilla transactions that cover the small to mid ticket markets** and are in fact very different to the sophisticated, structured big ticket leases that are the focus of standard setters' concern.

- The European leasing industry therefore believes that **exempting leases of non-core assets** from the new standard would go some way to achieving a well balanced standard that meets the needs of both the users and prepares of financial statements. The underlying reasoning here would be to differentiate between an airline having to account for its aircraft leases under the complex new approach and having to treat its leased photocopies, forklifts or laptops in the same way.

- As leases are **specific instruments**, different to other forms of finance such as loans, they should be accounted for with measurement and presentation requirements that reflect their particular nature.

- The current thinking on subsequent measurement of leases will lead to significant effects on a **lessee's income statement**. To avoid such impacts, the European leasing industry recommends a measurement approach that reflects the specificities of leasing by recognising that the asset and liability side of a lease are **linked**.

- Furthermore, requiring **separate presentation** of leases would significantly contribute to improving the information in financial statements as this would allow readers of accounts to distinguish between leased and owned assets and to identify the operating cash flows related to leases in the income and cash flow statements.

- To date, standard setters have been considering **lessee accounting** issues separately from those for lessors. It is the European leasing industry's view that this is regrettable and will be **generative of inconsistencies** in accounting standards.

About Leaseurope

Leaseurope is the voice of leasing and automotive rental in Europe. In 2007, the firms represented through the Federation's 46 Member Associations in 34 countries across Europe granted new leasing business worth in excess of €340 billion, making the European leasing market the largest in the world.

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January 2009

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are currently in the process of developing a new standard for international lease accounting. The Boards have taken the decision that this review, expected to be completed by June 2011, will apply to lessee accounting only. A Discussion Paper, setting out the standard setter's initial views on the direction the new standard for lessees will take, is expected in the first quarter of 2009.

By concentrating on some of the most important concerns that the new approach to lease accounting raises, this document attempts to provide an overview of the European leasing industry's preliminary reactions to a draft version of the aforementioned Discussion Paper made available to the public in October 2008.

Leasing is a key financing tool for European business, particularly for SMEs

In 2007, European leasing companies represented through the member associations of Leaseurope granted new leasing volumes worth in excess of EUR 340 billion, making the European leasing market the largest in the world. These leases were used to finance equipment, vehicles and real estate throughout Europe and Leaseurope estimates that in 2007, the European leasing industry financed around 20%[1] of all European investment and approximately 30% of investment in moveable assets.

These figures clearly show that leasing makes a considerable contribution to the European economy by providing businesses with finance for their investment needs in tangible assets. In particular, a significant share of Europe's SMEs use leasing as a source of external funds. One survey estimates that within the EU, 39% of all SMEs make use of leasing[2].

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[1] Excluding investment in private dwellings

[2] Exco Grant & Thorton Survey of SMEs (2001). In comparison, the survey estimates that 46% of SMEs in the EU use bank loans.

The new approach to lease accounting

The new approach to lease accounting would see a lessee recognise an asset and corresponding liability on its balance sheet. This asset is the right to use the leased item. Consequently, the approach is different to the current international standard for leases, IAS17, which distinguishes between finance leases (where the leased asset is shown on the balance sheet in a similar way to owned assets) and operating leases (which are not included on the balance sheet but where details are reflected in the notes to the financial statements). However, in practice, the users of accounts such as rating agencies, equity analysts and lenders already make adjustments to lessee financial statements in order to take into account lease payments that are not capitalised. As a result, it is likely that capitalising rights of use will make little difference to these users' assessments of a lessee's financial position.

Putting leases on the balance sheet will increase capital requirements

However, lessees should be aware that, as they will have more assets on their balance sheets under the new approach, they may need to hold additional capital for these assets. Given the current economic climate and the fact that capital is in short supply, the impact of the proposed changes on business activities is likely to be significant. For instance, for lessees operating in regulated industries such as banking, the impact on capital ratios may be very important.

A new standard for lessee accounting should not lead to unnecessarily complex accounting treatment

The single most important concern of the European leasing industry is that a new standard for lease accounting will be unnecessarily complex, leading to lessee accounts being less understandable and comparable than they are today. This would not meet with standard setters' objectives and may very well cause unforeseen commercial consequences, with leasing being placed at a disadvantage compared to other financing solutions. Such effects could be disproportionate to the economic benefits that leasing offers.

While the objective of this paper is not to go into detail on all possible changes to IAS17, it is important to note that within their review of lease accounting, standard setters are also considering very wide ranging changes. For example, it may fall upon lessees to make estimates of the lease term, of future contingent rentals and of the likelihood of exercise of purchase or extension options, not only upon initial recognition, but also at each reporting date. The additional work for lessees will be significant and the inevitable diversity of approaches to such estimates may well make financial statements less comparable than before.

While the changes currently under consideration concern IFRS accounts, it is important to note, given the significance of leasing for Europe's small and medium businesses, that were these changes to become applicable to local accounting rules, their complexity would weigh heavily on the large proportion of SMEs that opt for leasing as a source of finance.

Lease contracts are entered into for valid economic reasons, regardless of financial statement presentation. Consequently, run of the mill leases in particular should not be accounted for under complicated rules which may detract from their commercial advantages.

It is important to note that the "sophisticated", structured, big ticket lease transactions that are the main focus of the IASB/FASB's concern do not make up the major part of the European leasing business. Instead, the vast majority of European leasing transactions cover the small to mid ticket markets, where the reason for choosing to lease is not to achieve a certain type of accounting presentation. Instead, firms prefer to lease for the following reasons:

- Leasing provides them with the possibility to finance 100% of the purchase price of an asset without having to offer any supplementary guarantees
- They can better manage their working capital by spreading payments over the life of the asset
- Budgeting exercises are made easier as lease payments are regular and often for a fixed amount
- Leasing gives firms the opportunity to renew their assets, thereby ensuring that they can benefit from the latest available technologies and remain competitive
- Lessees can use the leased equipment without having to worry about considerations linked to ownership, such as the disposal of the asset when it is no longer used
- Leases are often accompanied by a range of optional services, including the insurance and maintenance of the leased asset. In this sense, a lease embodies an efficiently priced contract where all asset-related requirements can be outsourced to the lessor
- Leasing is easy to set up. It provides simplicity and process optimisation to the lessee who does not have to deal with accounting issues related to subsequent measurement of the asset such as depreciation, impairment or perform reconciliation with its fixed asset register
- In some jurisdictions, taking on a lease will enable the lessee to benefit from investment incentives (that the lessor can reflect through its pricing) which it might not otherwise be able to benefit from

These economic advantages of leasing are valid regardless of a company's size or nature. Any type of firm may choose leasing over other forms of finance for one or more of the above reasons. It is therefore essential a new leasing standard does not create costs for the preparers of accounts that are so significant that the commercial advantages of a lease transaction will be called into doubt. Instead, a thorough cost/benefit analysis of a new standard must be conducted to ensure that any additional burdens imposed on preparers will lead to a commensurate improvement in information for users of financial statements. As a result, Leaseurope would recommend that standard setters pay particular attention to producing a standard that is proportionate in terms of the costs it will create for preparers of accounts, bearing in mind the quality of additional information it will provide for users.

Furthermore, the new standard should not consider that all leases are the same; exceptional transactions should not dictate accounting treatment for the majority of leases that are substantially different to tailor made large ticket leases. The focus of the new standard should be on making improvements to aspects of today's standards that are the most flawed without negatively affecting plain vanilla leases, which are entered into for sound economic reasons and not to achieve a certain form of accounting presentation.

Exempting leases of non-core assets from the new standard would go some way to achieving a well balanced standard that meets the needs of both users and preparers.

The draft Discussion Paper on lease accounting discusses possible exemptions for short term and/or immaterial leases seeks views on whether exemptions should be included in a new standard and, if so, how they should be described.

Given the need for simplicity in lease accounting, Leaseurope would very much welcome some exemption for small ticket leasing contracts, which as mentioned above make up a substantial share of the business it represents. These are the leases that will be the most affected by the complexity of a new standard but that are very different to the large, sophisticated transactions that are the focus of standard setters' concern. The considerable additional burden for preparers of accounts to apply a new standard to low value, high volume leases such as photocopier, forklift or company car leases will not bring about better information for users of accounts.

However, basing an exemption on the notion of "short term" raises issues as to how this is defined. Simply saying that this should cover leases under 1 year is arbitrary (i.e. creates a so-called bright line) and would not alleviate the complexity issues for, say, director company cars that are leased typically at terms of 2 to 4 years. Using the concept of materiality may also not be sufficient to avoid the difficulties mentioned above. When deciding whether an item is material, preparers would already have to shoulder the burden of this calculation. Furthermore, it is questionable whether applying very complex accounting rules to all leases regardless of their nature would actually provide readers of accounts with additional useful information and the cost it would present for preparers would be unduly burdensome.

As a result, the European leasing industry takes the view that an exemption should be built around the importance of the asset to the core business of the lessee. This would help to differentiate between an airline having to account for its aircraft under the approach presented in the draft Discussion Paper and having to treat its leased photocopiers, forklifts or laptops in exactly the same way. Similarly, a haulage business should have to account for their truck leases under the approach, but perhaps not for its photocopier or printer leases in the same way.

One way of describing such a difference would be to distinguish between leases of core and non-core assets, where non-core assets are *individually* immaterial, fungible and are not part of the production or distribution process of the lessee. Additionally, a maximum lease term could be set to ensure that leases of long term “strategic” assets are not exempt, although again this introduces a bright line and may not be necessary.

Leaseurope therefore strongly encourages that an exemption for leases along these lines be considered by standard setters. While the definition of “non-core” may need to be further refined, an exemption which captures this notion would clearly avoid significant and unnecessary costs for preparers. Moreover, additional disclosure in the notes of the accounts could provide further information on the types of leases that are covered by the exemption and how this has been determined by the preparer.

Real estate leasing is often very different to equipment leasing

In their discussions in preparation for the Discussion Paper, standard setters appear to have focused on examples of property leasing which have been subsequently extended to all types of leasing. It is however important to understand that the equipment leasing and real estate leasing business can be different and many practices common in real estate leasing are rare on the equipment leasing market. Some of these differences are as follows:

- By their very nature, real estate leases are granted for longer terms than typical equipment lease contracts and tend to be high value transactions,
- Features such as below market rents, rental holidays or contingent rentals based on the lessee’s performance linked to the use of the asset are features more frequently found in real estate than in equipment leasing contracts
- Sale and leaseback transactions are more common in real estate leasing than in equipment leasing

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Therefore, particular attention should be paid to ensuring that the very real differences between equipment and property leases are adequately covered in the proposed standard and that neither sector is penalised by reference to contract characteristics that largely pertain to the other.

Leases are specific instruments and should be accounted for and presented in the financial statements as such

Leases are contracts that give rise to the right to use an asset in exchange for a series of payments. Transfer of the lessee's obligation can only arise with the transfer of the *entire contract*, that is to say by transferring the right to use the asset together with the obligation to make payments.

The asset and liability side of a lease are therefore intrinsically linked, contrary to, say, a loan that is used to purchase an asset. The loan and the purchase have two *distinct* sources while the assets and liabilities associated with a lease arise from the same original contract.

The IASB and FASB have recognised that initial measurement of both the lessee's asset and liability should be performed on the same basis, i.e. at the present value of minimum lease payments. Indeed, it makes sense to treat both sides of the contract in the same way and to take into account the time value of money by showing discounted amounts.

The IASB has suggested that subsequent measurement of the lessee's asset and liability be performed according to a de-linked approach to the lease contract. On the one hand, they suggest the liability be apportioned between a finance charge and a reduction of the outstanding liability according to an effective interest method and, on the other, they recommend that the asset be accounted for by allocating a depreciable amount on the same basis as for owned assets. Many consider that this will nearly always result in the use of straight line depreciation.

However, in the case of a straightforward lease contract with regular rental payments, the lessee is paying for the right to use the asset at the same time as it a) receives this right and b) consumes its economic benefits. With the initial carrying amounts of the right to use asset and the liability of the rental obligation being determined on exactly the same basis, it is logical that subsequent carrying amounts also be determined on that same basis. There does not appear to be a justification for the de-linked approach envisaged by standard setters where the discounting relating to the asset is reversed on a straight line basis while the discounting relating to the liability is reversed on a financial basis.

A lessee's income statement will be significantly impacted under the approach currently considered by standard setters

If a de-linked approach to subsequent measurement of the lessee's right to use asset and obligation to make payments were to be adopted by standard setters, it would seriously affect a lessee's income statement:

- In the earlier years of a contract, costs for lessees would dramatically increase thus depressing earnings, without any good reason other than accounting treatment
- The increase in costs would be greater the longer the lease term. For instance, the first year increase in expenses would be 7% for a 3 year lease and 21% for a 10 year lease. Over the first 5 years of a 10 year lease, costs would increase by 64%

Consequently, Leaseurope would be in favour of applying a linked approach to subsequent measurement as the impact on costs for lessees would be neutral. Examples of how a lessee's income statement will be affected under both a de-linked and a linked approach are presented in the appendix to this paper.

Equally, it is important to note that EBIDTA/EBIT measures will increase under the new approach as rental expenses are no longer recognised but replaced by depreciation and interest charges. This may impact a lessee's loan covenants and could lead to lessees having to renegotiate loans terms with their bankers.

Specific presentation for leases would contribute to improving the information in financial statements

Additionally, given that leases are specific instruments and the need to account for these as such, separate presentation in a lessee's financial statements is paramount as it would provide better information for users who will be able to distinguish leases from owned assets in the balance sheet and identify the operating cash flows related to leases in the income and cash flow statements. In other words, Leaseurope believes that separate presentation would bring about increased transparency and understandability of the accounts. Moreover, separate presentation would also facilitate specific accounting treatment for leases as there would no longer be a need to refer to existing literature for accounting for property, plant and equipment for instance.

Dealing with lessee accounting separately from lessor accounting is far from ideal

Due to a lack of resources and a link between lessor accounting issues and other ongoing IASB/FASB projects such as revenue recognition and derecognition, standard setters have decided to postpone a review of lessor accounting and to focus their work exclusively on lessee accounting, with the aim of reaching a finalised lessee standard by June 2011.

The European leasing industry has opposed this split and made its concerns known to standard setters. Indeed, there are a number of reasons for keeping lessor accounting within the review of lease accounting, including the following:

- European lessors specific concerns with lessor accounting that they would like to see resolved as soon as possible
- Separating the two sides of lease accounting would lead to asymmetric treatment for the industry for an unknown period of time, possibly generating confusion and uncertainty
- An analysis of the rights and obligations under a lease is best not considered from the point of view of only one party to the transaction.
- This may lead to double counting of the same asset. For instance, this would be the case if a right of use asset were to be recognised by the lessee (whereas it is not today) with the lessor also recognising a tangible asset.
- Many lessors are also lessees (for instance financial institutions or those with certain vendor programmes) and would have to manage parallel accounting treatments for the same products. This will be particularly different in cases of subleases where a lessor is a lessee of the same asset

A decision to split lessee and lessor accounting is therefore far from ideal and the European leasing industry believes that the disadvantages to this separate approach are significant and generative of inconsistencies in accounting standards.

If standard setters are not in a position to undertake such a review at this point in time for the reasons given above, additional guidance for sublease situations is a sine qua non condition if a new standard is to have any chance of working in practice.

APPENDIX

How changes to today's lease accounting standard affect a lessee's financial statements – a numerical example

The following example compares the accounts of a lessee of a simple lease for a computer workstation under (i) the current standard for leases, IAS17, where the lease is assumed to be an operating lease (ii) the new approach envisaged by standard setters where the right to use asset and the corresponding obligation are de-linked and (iii) a possible alternative to this approach where the asset and obligation are accounted for under a linked method.

The characteristics of the contract are as follows:

- Equipment cost: 4 000 EUR
- Lease term: 36 months
- Lessor's residual: 15%
- Monthly rental: 110.54 EUR

It is assumed that the lessee's incremental borrowing rate is 8%.

For sake of simplicity and given the existence of diverging tax regimes and rates throughout Europe, taxation has been ignored in the example. Nevertheless, it should be noted that under the new approach, where the asset and liability are de-linked, burdensome tax/book differences will arise.

It should also be noted that although some preliminary discussions on the financial statement presentation of leases have been held, few tentative decisions have been taken on this issue as the IASB is awaiting the outcome of the Financial Statement Presentation project.

Comparative Financial Statements

	IAS 17 Operating Lease				Approach Envisaged by IASB/FASB: *De-linked* asset & liability				Possible Alternative to New Approach: *Linked* asset & liability			
	Initial	YR 1	YR 2	YR 3	Initial	YR 1	YR 2	YR 3	Initial	YR 1	YR 2	YR 3
Balance sheet												
(Leased) Fixed assets	0	0	0	0	3,528	2,352	1,176	0	3,528	2,444	1,271	0
Financial liabilities	0	0	0	0	3,528	2,444	1,271	0	3,528	2,444	1,271	0
P&L												
Rent expense		1,326	1,326	1,326								
Depreciation		0	0	0		1,176	1,176	1,176		1,083	1,173	1,271
Interest expense		0	0	0		243	153	56		243	153	56
Net result		1,326	1,326	1,326		1,419	1,329	1,232		1,326	1,326	1,326
P&L Earnings Format												
Income		2,000	2,000	2,000		2,000	2,000	2,000		2,000	2,000	2,000
EBITDA		674	674	674		2,000	2,000	2,000		2,000	2,000	2,000
EBIT		674	674	674		824	824	824		917	827	729
Earnings before tax		674	674	674		581	671	768		674	674	674