

**TO:**  
Stig Enevoldsen  
Chairman, EFRAG Technical Expert Group

## **Leaseurope's response to EFRAG's Draft Comment Letter on the IASB's Discussion Paper – Leases: Preliminary Views**

---

Dear Stig,

This letter sets out Leaseurope's comments on EFRAG's Draft Comment Letter (DCL) on the IASB's Leases Discussion Paper (DP).

We have focused this response on what we view as being the most important issues raised by the IASB's DP, as well as on particular elements of feedback that EFRAG is seeking. Generally, we take the view that EFRAG's DCL addresses most of our concerns with the DP and we have highlighted those areas that we believe EFRAG should give further consideration to in its final response to the IASB.

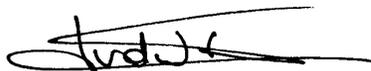
Our full response to the questions raised in the DP can be found in our comment letter to the IASB which we will communicate to EFRAG. We encourage EFRAG to refer to this for further information on our position regarding the individual DP questions.

This letter also covers the important issue of recent developments in lessor accounting. In this area, we call upon EFRAG to ensure that the IASB fully respects the due process that is expected of such body and that a discussion paper phase is not neglected for lessor accounting. We believe that this is necessary in order for EFRAG to appropriately fulfill its mandate to provide input on the consequences of proposed accounting standards for firms operating in a European environment.

We have very much appreciated the willingness of EFRAG to engage with Leaseurope on this important project and remain committed to working closely on lease accounting with EFRAG and its staff going forward.

Please do not hesitate to contact us or Leaseurope staff (Jacqueline Mills, [j.mills@leaseurope.org](mailto:j.mills@leaseurope.org) - +32 2 778 05 66) for any questions you may have on our comment letter.

Yours sincerely,



Tanguy van de Werve  
LEASEUROPE DIRECTOR GENERAL



Mark Venus  
CHAIR, LEASEUROPE ACCOUNTING COMMITTEE

## **A case for changing today's lease accounting model must be made**

Leaseurope believes that before any further work is done to develop a new lease accounting model, the IASB must prove that the existing model for leases is effectively broken and identify those areas where it is the weakest. We do not feel that the first chapter of the DP (Chapter 1 – Background) adequately makes this case.

To us, it would seem that the logical place to start the standard setting process would be to examine the extent and nature of leasing in Europe (and other IFRS jurisdictions). Only once this exercise has been conducted will standard setters be able to understand whether today's model is effectively broken, and for which types of leases, and consequently be in a position to design a new standard which addresses any identified flaws of the existing model in an effective and proportionate manner.

To get the accounting for leases right, it is also critical that standard setters understand firms' motivations for leasing and realise that in the vast majority of cases, businesses do not choose to lease to achieve a certain form of financial statement presentation. Instead, they choose to lease for a multitude of other, very valid economic reasons<sup>1</sup>. Basing the creation of a new model for lease accounting on the premise that companies use leasing as a structuring tool is very likely to end up in a standard that will not be appropriate for the vast majority of firms who lease either to be able to finance the use of an asset or because they want to benefit from a degree of flexibility without bearing the risks related to the asset.

Leasing is a very important source of finance for European businesses. Indeed, Leaseurope estimates that, on average, around 20% of European investment is financed by leasing. We would therefore encourage EFRAG to ensure that the IASB undertakes the appropriate analysis before producing a standard that could have a significant impact on European firms' use of leasing, particularly given the current climate where funding is scarce. If this analysis reveals that structured or big ticket operating leases that should give rise to assets and liabilities for the lessee occur more frequently for certain types of assets (e.g. real estate), efforts should be focused on these leases, instead of putting all contracts in the same bag. Any new standard must aim to remedy those areas where today's model is weakest, but this should not be done at the expense of plain vanilla leasing.

### **Timeliness of the review**

Given the significant number of ongoing IASB projects and current developments, including the financial crisis that has led to the Board having to undertake urgent work in the field of financial instruments and fair value accounting, it is not obvious that lease accounting should be a priority for the IASB, nor that users and other constituents consider it to be so. From our efforts to reach out to the user community during the comment period, it has been clear that lease accounting is of far lower priority for them than are other current IASB reforms.

As a result, in order to produce an effective and efficient improvement to current lease accounting, EFRAG should encourage the IASB to at the very least consider revising the disclosure requirements for today's operating leases in a way that will better meet user needs instead of proposing an entirely new lease accounting model. At this stage, there is a very real risk that a completely revised approach will be rushed and consequently ill thought out.

---

<sup>1</sup> Please refer to our response to the IASB for a full description of the reasons firms chose to lease

## **An impact analysis must be conducted before proceeding further with the project**

Leaseurope's major concern with the right of use model proposed in the DP is that it will create excessive complexity and burdens for preparers. Although no firm will be immune to this complexity, it will be those companies who have small ticket leases, very far removed from the structured, high value transactions that are at the core of the leases debate and users' concerns, who will be the hardest hit.

While the areas of complexity we have identified are fully described in our response to the IASB, we feel it is useful to summarise them here. For instance, 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 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. Requiring firms to make assessments of their most likely lease term or contingent rental payments will create significant burdens as many companies will simply not possess the data or the resources to do so. Requiring reassessments of these estimates at each reporting date will lead to even more costs for lessees. Additionally, lessees opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. However, under the DP proposals, in the future these lessees will be required to account for their leases in a way that destroys this simplicity.

The model set out in the DP will also have other consequences. For example, firms operating in regulated industry will have to hold additional capital for the new assets they will have for their leases under the new approach. EFRAG must call on the IASB to engage with prudential regulators on this issue, particularly in light of requests of the European Commission and EU Finance Ministers for increased cooperation and coordination between the IASB and the appropriate bodies responsible for financial supervision.

Therefore, if a case is made that current IFRS lease accounting needs to be revised in the short term, it is essential that an impact analysis of the right of use model be conducted before proceeding to an exposure draft phase, which will effectively be a working draft standard enshrining the principles announced in the DP. EFRAG should ensure that such a cost/benefit study of the new model is conducted by the IASB, 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<sup>2</sup>. If this is not done, it is very likely that the many European businesses who lease may no longer choose to do so in the future because the accounting model is so costly to apply. Many of these firms will struggle to find other ways of financing their asset needs and this will ultimately have repercussions on the entire European economy.

### **The single asset and liability approach**

In its draft response to questions 5 and 13 of the DP, EFRAG explicitly seeks constituents' feedback on the single asset and liability approach to lease accounting.

Leaseurope agrees with those EFRAG members who believe that this approach will result in amounts being recognised that are not understandable or comparable and misrepresents the flexibility the lessee has. Indeed, we take the view that such an approach is inconsistent with the IASB's Conceptual Framework and will not provide users of accounts with improved information.

---

<sup>2</sup> European Commission's Contribution to the IASCF Constitution Review, 22 June 2009

While we would tend to agree that individual components of a lease such as options, etc. may meet asset and liabilities definitions, because of the difficulties in measuring lease components, such an approach would simply not work in practice. For example, there is no market for options to extend or terminate a lease and lessees cannot determine their value on a standalone basis.

However, this does not mean that a single asset and liability model is a sound alternative. Components that cannot be measured should not be recognised, in concordance with the Conceptual Framework. This approach would also be extremely costly and difficult for preparers to apply and would not necessarily facilitate users' understanding of accounts. We feel that the IASB's preference for this approach results from the absence of the cost/benefit analysis mentioned earlier.

Indeed, neither the recognition nor the measurement approach to options discussed in the DP are satisfactory solutions from our point of view.

Under the recognition approach, firms will simply be recognising liabilities they do not have. Lessees are committed only for the initial lease term; they have no obligation to make payments beyond this original period. Moreover, users are likely to want to understand what a company's firm commitments are. The inclusion of rights and obligations under optional periods will cloud this view and will not reflect the fact that the lessee has chosen to negotiate a contract with its lessor allowing it to benefit from an adjustable right to use a certain asset. As identified by some EFRAG members, this model also completely fails to take into account the flexibility conveyed to lessees via the option. The flexibility that leases with options convey should not be underestimated as it is one of the key reasons why companies choose to lease instead of buy and can be an inherent part of their company's operating model.

The measurement approach is equally inappropriate as it would require reliable measurement of probabilities of the option exercise. Preparers will be unable to ascertain these probabilities (if they could, they may actually be able to calculate the value of the option on a standalone basis).

There are also common difficulties to both the recognition and measurement approaches to options. Particularly at the outset of the lease, but also throughout the contract term and right up until the point of exercise, it is unlikely that the lessee will have a reasonable view of the expected period of use of the asset. If it did, it would perhaps have chosen to buy the asset or would have leased it for a fixed term. Therefore, the requirement for lessees to "look through the option" is probably unfeasible or, at best, an extremely burdensome exercise involving a significant amount of guess-work.

Leaseurope also takes the view that the single asset and liability approach is not appropriate for dealing with contingent rentals<sup>3</sup> as this approach would imply that the lessee may be recognising obligations that it has the discretion to avoid in certain circumstances, again not respecting Conceptual Framework definitions. Moreover, given that there is a single lessee liability, the model amalgamates lessee liabilities that are financial in nature and those that are not. Lastly, this approach fails to take into account the fact that there are very different kinds of contingent rentals that therefore warrant different accounting treatments depending on their nature. Treating all contingent rentals in the same way is therefore not likely to provide better information for users of financial statements.

---

<sup>3</sup> EFRAG also particularly seeks feedback on its draft response to question 17 of the DP (probability weighted approach vs most likely rental payment approach for contingent rental payments). We refer EFRAG to our response to the IASB on this topic.

Consequently, Leaseurope would recommend that, if, and only if, a case has been made that the current lease accounting model needs to change, a finance lease type model should be envisaged where only committed lease payments would be capitalised. In our view, in comparison to the single asset and liability approach model set out in the DP, this would be more consistent with the Conceptual Framework and much more straightforward to apply as it would avoid a significant amount of the complexity created when dealing with options, contingent rentals and residual value guarantees.

## **Other issues**

While we invite EFRAG to consult our response to the IASB for our comments on the many other questions raised in the DP, we feel that it is important to highlight the following other issues that we feel EFRAG should address in its final response to the IASB.

### **1) Leases with services**

We believe that it is particularly important to stress the issues that arise under the proposals for leases including services, often termed “full service leases”. We entirely agree that service payments should not be capitalised along with payments for the right to use asset, as this would be inconsistent with other accounting literature. However, many lessees do not have information on service payments and if they are required to estimate these, part of the economic rationale for opting for these contracts, which are today accounted for as operating leases, falls away. Firms simply want to be able to use assets in exchange for a single invoice that represents an operating expense.

These kinds of contracts are prevalent in the automotive, IT, telecom, printing and photocopier leasing markets, to name but a few, and are becoming increasingly popular as firms choose to focus on their core activities and outsource those asset needs that are auxiliary to their business. If lessees have to dedicate resources to estimating service components, there is a very significant risk that the entire business model for these types of leases will be jeopardised. We therefore take the view that EFRAG should consider the impacts of the new proposals on these types of leases in particular in their comment letter to the IASB.

### **2) Scope exemptions**

As we have explained, our main concern with the approach set out in the DP lies with its complexity. Therefore, we view the question of any possible scope exemption purely as being a cost/benefit issue. The difficulty with proposing a scope exemption is of course how to define such an exemption. Nevertheless, the complexity, and consequently the costs of the proposed model, will be disproportionate, particularly for the users of straightforward, small ticket leases. A solution must be found to alleviate these burdens, be it through the development of specific materiality guidance for leases, a scope exemption or preparer judgment.

While this is a decision for national standard setters, if the model suggested in the DP were to apply to SMEs as it is, it is likely that these types of businesses would simply not be able to lease any longer. It has been estimated that 51% of SMEs<sup>4</sup>, the backbone of the European economy, have made use of leasing or rental. Leasing is therefore a key source of finance for these businesses and their use of the product should not in any way be undermined. The influence of IFRS standards on local GAAP must not be ignored and EFRAG should ensure that the impacts of the proposal currently under consideration will not negatively affect Europe’s small businesses in the longer term.

---

<sup>4</sup> SME Access to Finance, Flash Eurobarometer 174, TNS Sofres/EOS Gallup for the European Commission, October 2005.

### 3) The link between the asset and liability inherent in a lease must be reflected

Leaseurope take the view that in a lease, the asset and liability are linked. Consequently, they should be presented as specific categories in the balance sheet to facilitate users' understanding. Their subsequent measurement should therefore also reflect this situation.

A linked-approach to subsequent measurement does not necessarily have to be the one described in the DP. Instead, Leaseurope recommends that the lessee's liability should be apportioned between a finance charge and a reduction in the outstanding liability as this would be consistent with the treatment of other financial liabilities given that an interest expense would be shown by the lessee. The decrease in the lessee's right of use asset value should be determined by using mortgage-based amortisation. This would best reflect the pattern of consumption of economic benefits of the lessee's right to use asset as the lessee effectively uses the asset as it pays for it. Furthermore, this approach would not preclude the recognition of situations where the lessee's asset and liability are no longer linked, for instance in situations where the right to use asset were to become impaired or if the asset were to increase in value without a change to the lease payments. Impairments or revaluations could still be performed in these cases.

We would therefore encourage EFRAG to consider this approach to subsequent measurement in their final response to the IASB as it better reflects the very specific nature of lease assets and liabilities and leads to lessees recognising a straight-line expense in their P&L, contrary to the DP approach which will result in lessees showing an upfront increase in costs for no other reason than accounting treatment.

#### **Lessor accounting**

As EFRAG is aware, the DP does not cover lessor accounting, with the exception of a very high level chapter simply sketching out some of the issues relating to a lessor model and providing no preliminary views. Additionally, the IASB did not publicly deliberate any of these issues prior to publishing the DP. Consequently, in our view this last-minute addition to the paper should not be taken as implying that lessor accounting has been duly considered by the IASB.

At the outset of the lease accounting project, the IASB's intention was to fully review all aspects of lease accounting. However, lessor accounting was subsequently deferred. Leaseurope was very much opposed to this decision, along with a number of other associations representing the leasing industry across the globe, for the reasons set out in our 11 June 2008 letter to the IASB.

Nevertheless, the IASB and FASB have been working on a lessor accounting model during the comment period to the DP. In May 2009, the IASB took tentative decisions on a lessor accounting model that fundamentally contradict the basis for the lessee accounting model set out in the DP. The entire right of use model developed for lessees rests on the IASB's conclusion that the lessee's obligation to pay rentals meets the definition of a liability. The justification for this decision is that the lessor's performance under the lease is completed upon delivery of the asset/signature of the contract. We therefore fail to see how the IASB can arrive at the entirely opposite conclusion when looking at a lessor model. One can only conclude that the decisions taken on the lessee side would need to be entirely revisited if the Board were to confirm that the lessor had a continuing performance obligation, as it is hard to escape the conclusion that such contracts are therefore executory. This is a clear example of why it is so important to consider lease accounting from the point of view of both the lessee and lessor.

Leaseurope is of the opinion that by not sufficiently communicating on lessor accounting issues and failing to consult stakeholders in the form of a discussion paper, it is highly questionable whether the due process that would be expected from the IASB has been appropriately followed. Consequently, we have communicated these concerns to the IASC Foundation Trustees and their Due Oversight Committee<sup>5</sup>. This issue is scheduled to be discussed at their meeting of 7 July 2009.

Over and above this conceptual inconsistency and the due process issues noted above, the approach to lessor accounting currently envisaged would have very significant, practical implications. Lessor balance sheets will be significantly inflated as lessors effectively double up their assets with a receivable for their right to receive rental payments and the leased asset remaining on their balance sheets. Consequently, regardless of their nature, all lessors, including financial institutions, will retain physical assets such as planes, cars, equipment, etc. on their balance sheet, even though they may have no continuing involvement with the asset, apart from legal title. Manufacturing companies or dealers who use leasing as a means of supporting the sale of assets will not be able to recognise any profits on these transactions. Many vendor leasing programmes will also no longer be viable.

Moreover, a significant number of European leasing firms belong to banking groups. As a result, European banks have to hold a minimum amount of capital for their lease exposures in accordance with the Capital Requirements Directive. If in the future lessors have two assets for their leases, a receivable and a physical asset, they will have to hold capital for both of these and this could lead to institutions having to effectively double their regulatory capital for leasing activities. In some cases, the effect could even be higher. The upshot will simply be that financial institutions will no longer consider leasing to be a viable business and will cease to operate in this market, thus depriving the European economy of a vital source of funds.

While it is uncertain as to how the Boards will proceed with respect to lessor accounting, given that the IASB is now working on lessor accounting in spite of their previous decision to defer the issue, there is a distinct possibility that a lessor accounting model will be included in an exposure draft phase without any preliminary public consultation in the form of a discussion paper. Yet it is essential that lessor accounting is fully analysed and deliberated by the IASB, that its constituents are appropriately consulted and that the same due process steps that have been followed for lessee accounting apply to lessor accounting too.

In other words, Leaseurope is of the opinion that a comprehensive discussion paper phase cannot be avoided for lessor accounting. If a discussion paper fully covering lessor accounting issues is not produced, we would take the view that the IASB will not have fully respected their original due process commitments with the very possible consequence of the Board not achieving an improved, high quality financial reporting standard for leasing.

Consequently, Leaseurope requests that EFRAG's response to the IASB addresses these issues and that EFRAG calls for a full discussion paper phase for lessor accounting so that it is able to adequately fulfil its objective of providing input on the consequences of proposed standards for companies operating in the European environment.

---

<sup>5</sup> Please refer to our letter to the IASC Foundation Trustees of 24 March 2009 for further information.