



The Voice of Leasing and Automotive Rental in Europe

IASB LEASE ACCOUNTING PROJECT LEASEUROPE UPDATE OCTOBER 2014

Contact person:

Julian Rose

Leaseurope

+32 2 778 05 60

j.rose@leaseurope.org

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Leaseurope AISBL

Bld. Louis Schmidt, 87 b.3 B-1040 Brussels | Tel: +32 (0)2 778 0560 | Fax : +32 (0)2 778 0578 | www.leaseurope.org

CLARIFYING THE STATUS OF THE IASB LEASE ACCOUNTING PROJECT

In August, the International Accounting Standards Board (IASB) staff published a Project Update on Leases. The IASB document provides an update on the most important tentative decisions reached on the Leases project during the first half of 2014, explains the IASB's reasons for reaching those decisions and explains the remaining work to be done in completing the project. It states that the IASB expects to issue a new Leases standard in 2015.

Leaseurope, the European Federation of Leasing Company Associations which is composed of 44 member associations in 32 countries, considers that at this key stage a more complete analysis is needed of the status of the Leases project than was provided in the IASB document. Our Project Update therefore aims to assess the project against the IASB's own objectives from when the project started in July 2006. It summarises our understanding of the IASB's staff analysis relevant to each objective and sets out Leaseurope's own analysis.

None of the five main objectives of the project are likely to be achieved by the current proposals. Even with the adjustments and clarifications that the IASB has discussed in its recent deliberations, the proposals will not achieve greater consistency between similar transactions and will not achieve more relevant and reliable reporting. The proposals do not improve consistency with other accounting standards or achieve convergence with FASB. Most importantly for European businesses, the proposals bring great complexity and cost with doubtful benefits to users of their accounts, including the investors who own their shares.

The European equipment leasing industry supports around €240 billion of new investment by European businesses of all sizes each year. It is of particular importance to SMEs, many of which will be affected by these proposals once they are carried across to IFRS for SMEs and national accounting standards, as is likely to happen. The current proposals will put business investment at risk and so damage the growth prospects of European businesses, in direct conflict with the European Union's agenda for growth. The new rules will also harm efforts to achieve environmentally sustainable growth in Europe.

Particularly at a time when the European Central Bank is investing heavily in facilitating credit provision to improve the business environment for European firms, the IASB should not issue a new Leases standard until it is clear that the project objectives will be achieved. Instead the IASB should focus on making improvements to the existing leases Standard, building on the work done over the eight years that this project has been running and reflecting the conclusions of the IASB's ongoing review of its conceptual framework.

Mark Venus
Chair, Leaseurope Accounting Committee

WHAT ARE THE PROJECT OBJECTIVES?

The following objectives are summarised from Paper 9A of the IASB Board Meeting of 19 July 2006¹, when this project was launched.

Greater consistency between lease transactions

Address concerns over inconsistent interpretation of the IAS 17 that results in similar transactions accounted for differently, and provides an incentive to structure transactions to achieve the preferred accounting treatment.

More relevant and reliable reporting

Improved relevance and reliability of reporting of leasing transactions based on conceptually sound and consistent principles that more accurately reflect the rights acquired and obligations assumed in a leasing transaction.

Greater consistency with other accounting standards

Improve IFRS by treating leases consistently with other types of transactions, making the accounting for leases more consistent with the principles underlying other accounting standards.

Convergence with FASB

Achieve an important FASB convergence objective (although the main driver of the project is improvement rather than convergence).

Balance of costs and benefits

Balance the costs and benefits of the new model, with the benefits being largely in terms of improved financial reporting and financial statements that more accurately reflect the true nature of the transactions entered into.

¹http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Meeting-Summaries-and-Observer-Notes/Documents/ObNotes_LP0607ob09a.pdf

OBJECTIVE 1: GREATER CONSISTENCY BETWEEN LEASE TRANSACTIONS

IASB analysis

- Reporting all leases in the same way removes concerns over inconsistent interpretation of the lease classification guidance in IAS 17.
- Reporting all leases in the same way reduces any incentives to structure transactions as operating leases or finance leases.

Leaseurope analysis

- The proposals create a significant new risk of inconsistent interpretation by moving the key accounting 'dividing line' from operating lease vs. finance lease to the lease vs. service distinction that was previously of minor importance.
- Even if the proposed guidance on separating leases and services is improved, small contractual variations between different arrangements with similar economic results will lead to significant differences in accounting treatment.
- As the European economy moves towards more sustainable relationships between producers and customers based on new and more service-oriented business models and new ways to define product ownership and responsibility (as set out in the European Parliament's 2012 Study, The Leasing Society²) increasingly the boundaries between leases and services will become more difficult to define.
- The suggestion in the IASB staff paper that IAS 17 incentivises European businesses to structure transactions to achieve particular accounting outcomes ignores the underlying economic benefits that drive the decision to lease, ignores the fact that off-balance sheet leases are described - often in detail - in the notes to the accounts, and unjustifiably casts doubt over the professionalism of accountants and auditors.
- By excluding lessor accounting from the proposals, an inherent and fundamental new inconsistency in the reporting of leases will be created.

² http://www.europarl.europa.eu/RegData/etudes/etudes/join/2012/492460/IPOL-ENVI_ET%282012%29492460_EN.pdf

OBJECTIVE 2: MORE RELEVANT AND RELIABLE REPORTING

IASB analysis

- Proposals lead to a more complete balance sheet picture of the liabilities of a lessee.
- Proposals are based on the fact that, at the start of lease, the lessee obtains a right to use an asset for a period of time.

Leaseurope analysis

- It is likely that users of lessees accounts will still decide to adjust lessees' balance sheets e.g. if they wish to assess the value of assets in use rather than liabilities to the lessor.
- Users will not know whether reported lease liabilities are finance-based or are executory (service-based) where the lessee does not bear the risks and rewards associated with the leased asset (at a time when service-like contracts are the fastest growing segment of the leasing market).
- The staff paper cites examples of retailers in the US and UK that have gone into liquidation having substantial (property) operating lease commitments but there is no evidence whatsoever that the accounting treatment of their leases contributed to their problems or to any inability of investors to understand the retail chains' financial position.
- The exclusion of lessor accounting will distort the balance sheets of large numbers of European businesses (a majority of IFRS users in some countries) that are both lessees and lessors e.g. sub-let property.
- If the quantity of disclosures has to increase compared to IAS 17 (as it proposed) this seems inconsistent with the claim that financial statements will provide more relevant and reliable information

OBJECTIVE 3: GREATER CONSISTENCY WITH OTHER ACCOUNTING STANDARDS

IASB analysis

- The IASB considers that all leases create assets and liabilities. The 'Right of Use' Model is more consistent with other accounting standards as it treats all leased equipment as assets and liabilities of the lessee. Currently long-term liabilities of the heaviest users of off balance sheet leases in Europe may be understated by 20%.

Leaseurope analysis

- The proposals reduce consistency of accounting for leases (e.g. a 3-year equipment lease) compared with other non-cancellable service arrangements (e.g. a 3-year distribution contract).
- IFRS 15 (Revenue Recognition) sets criteria for when goods and services are distinct from each other, inconsistent with the criteria proposed for leases and services.
- The creation of an entirely different model for lessee compared to lessor accounting creates an inherent inconsistency within the leases standard.

OBJECTIVE 4: CONVERGENCE WITH FASB

IASB analysis

- The cost of accounting for leases under both models (IASB and FASB) is broadly similar, because the most significant costs for lessees arise from recognising leases on the balance sheet - the difference between the IASB's and FASB's lease model does not result in any difference in the measurement of lease liabilities.
- In practice, the difference between the IASB and FASB positions on recognition of leases expenses is expected to result in little difference for many lessees for portfolios of leases.

Leaseurope analysis

- The differences between the principles of the IASB and FASB models are fundamental and their effects could be significant when comparing similar businesses e.g. in Europe and the US.
- Multinational companies will have to maintain different records for different reporting with no straightforward way to reconcile financial statements under the two separate models.
- The existing accounting standards IAS 17 and FAS 13 are substantially converged, hence these proposals represent a shift away from convergence.
- It is wrong to conclude that the differences between the IASB and FASB positions will result in little differences for many lessees, as this only applies if lessees have stable and mature leasing portfolios, whereas most lessees have more dynamic leasing requirements.

OBJECTIVE 5: BALANCE OF COSTS AND BENEFITS

IASB analysis

- Proposals lead to a more complete balance sheet picture of the liabilities of a lessee. The IASB has focused on the benefits of information provided to investors and analysts, but at the same time has considered the cost and complexity of the proposed changes.
- In response to concerns expressed about cost and complexity, a lessee is not required to recognise assets and liabilities for leases of 12 months or less. To address concerns about the costs to apply the proposals to large volumes of small items, the IASB is also considering an exemption for leases of small assets.

Leaseurope analysis

- The benefits to investors and analysts remain unclear - possibly being about convenience, or possibly about avoiding risk - but very difficult to measure and balance against the substantial extra systems and accounting preparation costs for European businesses.
- Although any simplifications and exemptions are welcome in reducing costs, in practice those proposed or under discussion are likely to affect small quantities of equipment leases and offer limited relief.
- The IASB has excluded from its analysis the effects of the proposals on SMEs when the proposals are rolled out via IFRS for SMEs and local GAAP (as is likely to happen) despite 99% of European businesses being SMEs.
- The IASB has given very limited attention to the effects of the proposals on other regulation, e.g. tax rules and banks' capital requirements, some of which could be substantial and present further risks to business investment in Europe.
- Having fundamentally different accounting models for lessee and lessor accounting cannot be an enduring solution and will inevitably lead to a further review of lease accounting, causing confusion and increasing costs and uncertainty.
- The IASB has not compared the proposals with the 'next best alternative', whether that is IAS 17 with improved disclosures and steps to review how the current rules are interpreted, or any other solution, which means that there is no way of knowing whether the proposals provide the optimum balance of costs and benefits.

WHAT ARE EUROPEAN BUSINESSES SAYING?

Many European businesses expressed concerns about the proposals in responses to the Exposure Draft and Revised Exposure Draft. Any simplifications to the proposals are welcome but those being considered are unlikely to make a substantial difference to the costs of preparing accounts under the proposed rules.

The possible simplifications and clarifications being discussed by the IASB also fail to address concerns amongst European businesses over whether the changes will help users of their accounts to understand their business models.

BUSINESSEUROPE, representing 41 member business associations in 35 countries, May 2014, letter to European Commission May 2014³

- *The decisions of the boards taken at their March meeting fall far short of satisfying the conditions of high quality and comparability which are essential for the replacement of existing standards. The divergent decisions taken indicate that, despite having worked together on this project for eight years, the boards have not been able to agree on fundamental principles of the future standard, namely, the objective of lease accounting and therefore the appropriate scope.*

.... BUSINESSEUROPE therefore believes that, in order to achieve a clear improvement over the existing standard, the IASB should continue to work on defining an objective and appropriate scope for leasing accounting. In particular the IASB must:

- *Provide a proper distinction between leases, services and other executory contracts, as suggested by EFRAG, in order to ensure that only lease contracts will appear on the balance sheet;*
- *Recognise the fundamental economic difference between leases which are essentially financed purchases of an asset and contracts which represent the purchase of flexibility for access to an asset or a purchase of services; and*
- *Ensure that there is a minimum level of consistency between accounting by lessee and lessors.*

In our view, these are fundamental pre-requisites for a high-quality, understandable and enforceable standard on leasing.

³ <http://www.businesseurope.eu/content/default.asp?PageID=664#Library>

WHAT ARE INVESTORS SAYING?

The IASB staff paper reports that in 2013 the IASB spoke to approximately 270 investors and analysts around the world amongst other outreach activities. The paper cites a letter from the Capital Markets Advisory Committee (CMAC), an investor advisory body to the IASB, which stated (specifically on behalf of those of its members who attended its October 2013 committee meeting) ‘...while a disclosure-only solution might be acceptable by expert users of financial statements, it would not be helpful to the majority of investors who require financial statements to provide them with clear information from the outset.’

Some investors, including the members of the CMAC represented in the letter to the IASB, may continue to support the project’s objectives. However most have not commented publicly on whether they expect the current proposals to actually achieve the project’s objectives without causing harm to the businesses in which they invest. Those that have generally do not approve the proposals.

Christopher Cox, former Chair of the SEC (Speech, June 2014⁴)

- *Of the 645 total comment letters, only 80 were from investors and other users of financial statements. That includes banks, asset managers, financial analysts, credit rating agencies, and organizations representing users of corporate reporting. Of these 80 letters from investors and users of financial statements, only 16 mostly approve or fully approve of the proposal in the latest Exposure Draft. Sixty-four of the letters are either critical of the proposal in material respects, or completely oppose it. In other words, only 20% of investors and users of financial statements approve of the leases proposal. Eighty percent don’t. And this is the group that standard setters claim to be most concerned with.*

FASB Investor Advisory Committee (report in Compliance Week, September 2013⁵)

- *“Overall, the idea that liabilities related to leases is something that would be helpful to investors -- it’s definitely the right idea to get more transparency on that,” said David Trainer, CEO of New Constructs and a member of the IAC. “However, I think the complexities of the underlying activity make it almost impossible to create a one-size-fits-all solution that we can just put on the balance sheet. The most decision-useful information is to enhance disclosure to let analysts who, given their multiple potential interpretations, can do with it what they wish.” He continued that the current proposal is based on accounting constructs that are difficult for many users of financial statements to understand. “I’d rather just have the data there and do with it what I think I need to do with it.”*

Société Française des Analystes Financiers (SFAF) Comments on IASB Exposure Draft September 2013⁶

- *...we consider that the proposed approach which aims at accounting both finance and operating leases under the same accounting methods doesn’t prove to be a convenient solution for users of financial statements. It adds some potential judgment in the value of assets and liabilities to be added on the companies’ balance sheets and opens numerous windows for arbitrage / structuration, while it doesn’t differentiate between the different natures of finance lease as compared to operating lease. We believe IASB would better help users of financial statements by improving the current IAS 17 standard in establishing a more robust frontier between both kinds of leases and by improving current disclosure (value of future rentals, table of future rentals detailed, year by year, disclosure about optional or contingent rentals...).*

⁴ <http://blogs.law.harvard.edu/corpgov/2014/06/11/how-americas-participation-in-international-financial-reporting-standards-was-lost/>

⁵ <http://www.complianceweek.com/blogs/accounting-auditing-update/fasb-panel-says-ditch-lease-accounting-proposal#>

⁶ <http://goo.gl/NPPU0p>

COMPLETION OF THE LEASES STANDARD NEEDS TO BE ALIGNED WITH THE IASB'S CONCEPTUAL FRAMEWORK PROJECT

The IASB staff paper notes that the distinction between a lease and a service will be critical, because that distinction would determine whether a lessee recognises assets and liabilities. In the vast majority of cases, this assessment is straightforward, the paper suggests. However, in some scenarios the distinction can be difficult to make and would require judgement. In response to feedback, some aspects of the guidance will be changed to make it easier to determine whether a contract contains a lease.

As the recent EFRAG additional consultation has shown, there remains considerable uncertainty over the distinction between leases and services. For equipment leasing this is likely to become a significant issue. Meanwhile IASB's Conceptual Framework Project, which is ongoing, is actively considering the definitions of assets and liabilities.

Getting a Better Framework: Our Strategy, paper issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC), January 2013⁷

- *We welcome the development of a new Framework. The IASB has been struggling for too long to complete major projects with the existing Framework, the inadequacies of which are generally recognised. As a result, some past proposals have been based on creative interpretations of the existing Framework: in other cases proposals have been based on concepts that are unclear and have not been generally agreed.... A new Framework should ensure that new standards are based on clear principles that the IASB's stakeholders understand and support.*

EFRAG comment on Exposure Draft Leases, October 2013⁸

- *...EFRAG recommends that the IASB take advantage of the discussion on the Conceptual Framework to refine the definition of the right - of - use, distinguish this right from the other rights which are bundled in the asset, consider the implications of the unbundling of the leased asset in the lessor's accounts and refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets). This lack of clarity in the conceptual model, in addition to the significant concerns below, means in EFRAG's view that the current proposals will not lead to improvements in financial reporting...*

⁷ <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/EFRAG-Getting-a-Better-Framework.aspx>

⁸ http://www.efrag.org/files/ED%20Leases%202013/ED_Leases_2013_-_EFRAG_Final_Comment_Letter.pdf

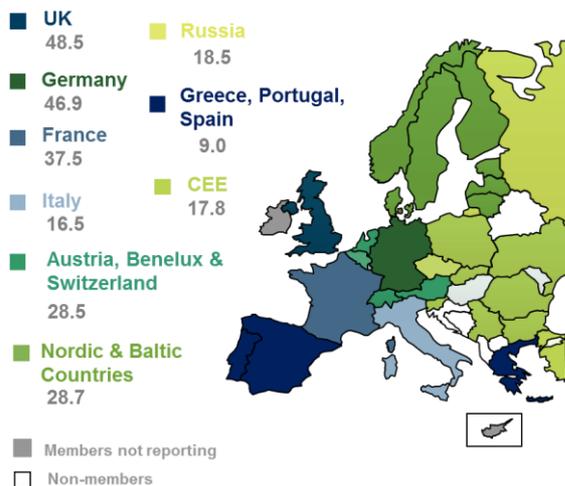
THE RISKS OF MAKING IT MORE DIFFICULT FOR EUROPEAN FIRMS TO USE LEASING

In 2013, European lessors granted new equipment (including vehicles) volumes of €238.4 billion. 22% of total investment in business equipment and vehicles in Europe is made using leasing.

Leasing is used by most large firms and by millions of European SMEs. Around 40% of all European SMEs make use of leasing, which is more than any other individual form of lending. Studies have shown that the majority of small businesses witness an improvement in their business performance as a result of using leasing⁹. Additionally, SMEs that use leasing invest on average 57% more than those who do not¹⁰.

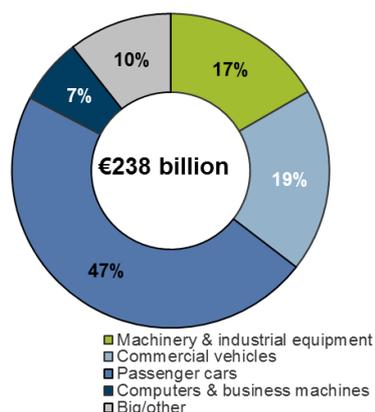
Leasing not only aids in replacing old, polluting equipment with cleaner and more energy efficient assets, it can also encourage the efficient use of scarce natural resources.

New leasing volumes per cluster in 2013 (in Bil €)



Source: Leaseurope 2013 Annual Statistical Enquiry

New leased equipment volumes per asset type in 2013



Due to their complexity and the consequent costs of implementation and operation by European businesses, the current proposals will put business investment at risk and so damage the growth prospects of European businesses, in direct conflict with the European Union's agenda for growth. The new rules will also harm efforts to achieve environmentally sustainable growth in Europe.

Particularly at a time when the European Central Bank is investing heavily in facilitating credit provision to improve the business environment for European firms, the IASB should not issue a new Leases standard until it is clear that the project objectives will be achieved. Instead the IASB should focus on making improvements to the existing leases Standard, building on the work done over the eight years that this project has been running and reflecting the conclusions of the IASB's ongoing review of its conceptual framework.

⁹ European Bank for Reconstruction & Development – EBRD (2011) Special Study: Bank's Leasing Operations (Regional)

¹⁰ Oxford Economics Report (2011) The Use of Leasing Amongst European SMEs