Leaseurope

The Voice of Leasing and Automotive Rental in Europe

PRESS RELEASE

FOR IMMEDIATE RELEASE

New lease accounting rules complicated, contradictory and costly

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Brussels, 17 August 2010 – The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have today released a draft standard on how businesses should account for their lease and rental transactions. The proposed standard contains complex accounting requirements that differ significantly from the existing treatment and will have huge impacts on businesses, potentially limiting their access to assets through leasing and rental.

The draft standard follows a round of consultation in 2009 during which the Boards received more than 300 comment letters, the majority of which stressed the need for the standard setters to simplify their initial proposals considerably. Judging by the document issued today, very little has been done to address these concerns.

Leaseurope, the body representing the leasing industry at European level, is concerned businesses' views have not been taken into account and that the IASB is simply steamrolling ahead to finalise the leases standard by its June 2011 deadline for converging some of its standards with US accounting standards. Although fully supportive of convergence between IFRS and US GAAP, Leaseurope fears that high quality standard setting for leases is being held hostage to this process.

"To date, the Boards have simply paid lip service to cost/benefit considerations. This is very visible in the draft standard that has just come out. The proposals are more than 100 pages in length only a handful of paragraphs deal with cost/benefit analysis", comments Mark Venus (BNP Paribas), Chairman of Leaseurope's Accounting Committee. He adds that "leasing and rental provides vital economic benefits for many businesses and there is a risk that these could be jeopardised unless the proposals are substantially simplified. Another cause for concern is the Boards' proposal for lessors, which is completely contradictory to what is being suggested for lessees. This raises fundamental questions as to whether the Boards have sought to build a coherent overall model and whether the current proposal makes any sense at all. Instead, it seems as though the proposal is trying to paper over some fundamental disagreements between the Boards".

The European leasing industry, together with its counterparts from across the globe, has repeatedly expressed concerns with the way accounting for lessors has been handled. Today's proposals clearly show that standard setters have been unable to produce a model that appropriately reflects the economics of these transactions for lessors. At worst, this could lead to lessors having difficulty in continuing to provide this key form of finance to businesses. At best, it will be an ongoing burden for lessors, without producing relevant and useful information for users of accounts. Under pressure from looming convergence deadlines, the Boards appear to have almost entirely ignored the straightforward solutions put forward by the leasing industry for lessor accounting.

Tanguy van de Werve, Leaseurope's Director General comments that, "we are disappointed the IASB and FASB have not yet taken on board the feedback that we and many others have provided. During the 4 month comment period to follow today's release, we urge European policy makers and business representatives to ensure that they are fully aware of the implications of the changes to accounting for leases and rental and encourage them to make their views on the proposals known to the Boards. In particular, we call on the European Commission and its advisory bodies to ensure that a robust impact assessment is carried out and that the final standard reflects the conclusions of this exercise before it is integrated into EU legislation."

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Notes to the editors

What is the process for changing today's lease accounting standard?

The project to change the existing accounting for leases is part of a series of joint projects that the IASB and FASB are undertaking together to converge their accounting standards. The deadline for most of these standards, including the leases standard, to be finalised is currently June 2011. The draft standard issued today can be obtained from the IASB's website and is open for public consultation for the next four months. This consultation will be the last opportunity for stakeholders to comment on the proposals before they are finalised.

What are the new proposals for lessees?

The proposals adopt an approach to accounting for lessees, known as the right of use model, that differs substantially from today's standard. 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. Under the current standard, a lessee recognises the leased asset only under so-called finance leases but discloses its commitments under other leases (operating leases) in the notes of its accounts.

What makes this so complex?

The new accounting approach involves several additional changes to "simply" requiring that more assets and liabilities are shown on the balance sheet. Lessees will have to make complex probability assessments related to their lease terms and lease payments and will have to reassess these estimates at each reporting date. Instead of deciding whether a lease is a finance lease or an operating lease, firms will now be faced with complex judgement calls when determining whether they have a lease contract or a service contract.

What are the impacts likely to be?

Businesses will see an increase in their leverage under the new proposals, possibly triggering existing debt covenants. Those operating in regulated industries, such as the banking sector, may be faced with higher capital requirements. Income statements will also be affected, with lease costs appearing to be higher in the earlier years of lease due to the accounting methods being proposed. Lessees are likely to experience a general increase in costs due to the significant changes in IT systems and internal processes and controls that will be engendered by the new proposals.

What are the new proposals for lessors?

While there will only be one way of accounting for leases from the lessee's perspective, the proposals envisage that lessors would apply two accounting models. Although the lessor recognises a receivable for its right to receive rental payments under both of these models, the accounting for the leased asset is very different under the two approaches. With the model known as the de-recognition model, the portion of the leased asset transferred to the lessee by virtue of the lease is de-recognised from the lessor's books. Under the second model, referred to as the performance obligation model, the lessor keeps the entire asset on its books and recognises a liability for an obligation to continue to provide the lessee with the asset over the lease term.

What are the concerns with the lessor proposals?

Conceptually, it is very difficult to understand why one model can cover all lease situations from the lessee's perspective but that lessors need two different models to deal with the same contracts. The circumstances under which the various lessor approaches would apply are also very unclear. Moreover, the performance obligation model is in complete contradiction with the lessee model which is based on the underlying principle that the lessor does not have a continuing obligation to provide the lessee with the asset throughout the lease.

While the de-recognition model is coherent with the approach adopted for lessees and appropriately reflects the economics of a lease transaction, the performance obligation model provides distorted information that will not be helpful to the readers of accounts. Return on assets, cost/income and many other ratios will be skewed under this approach. Moreover, unless capital requirement rules are adapted, bank-owned lessors applying the performance obligation model will see increases in their regulatory capital, although the risks they face remain unchanged. Ultimately, this is likely to have a negative impact on the availability of leasing as bank-owned lessors are amongst the most important providers of leasing in Europe.

Are there broader implications?

If the lessor accounting proposals have the effect of limiting the availability of leasing as Leaseurope expects they may, smaller firms in particular could have a much harder time financing their investments. These are firms with limited sources of external funding to begin with and, without the benefit of the collateral that leasing naturally incorporates, their borrowing may become more costly and difficult to obtain.

How important is leasing in Europe?

In 2009, European leasing companies represented through the member associations of Leaseurope granted new leasing volumes worth in excess of EUR 209 billion. These leases were used to finance various types of equipment, vehicles and real estate throughout Europe. Leaseurope estimates that in 2009, the European leasing industry financed just under 20% of all new European investments (excluding real estate)[1]. Of the total new leases granted in 2009, almost 90% were granted to finance various types of equipment and vehicles, with automotive leases making up more than 50% of all new business.

These figures demonstrate the considerable contribution leasing makes to the European economy by providing businesses with a means to finance their investment needs. In particular, a significant share of Europe's SMEs, the backbone of the European economy, use leasing as a source of external funds. It has been estimated that 51% of European SMEs have made use of leasing or rental[2].

Why do businesses lease?

In their many forms, leasing and rental are used by almost all businesses at some point in time. Leasing and rental products are easy to set up and offer a unique set of benefits to businesses. These include the possibility to finance the entire purchase price of an asset, use assets in a flexible manner without bearing the risks associated with ownership, manage working capital efficiently and simplify budgeting exercises. Additionally, leasing and rental products often include a range of associated services (such as insurance and maintenance) that effectively allow the user to outsource all of its asset-related needs to the lessor.

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[1] Leaseurope leasing penetration rate estimate based on total new leasing volumes reported in Leaseurope's 2009 Annual Survey, divided by total investment, excluding real estate, for the 23 countries and 30 members for which this data was available in the 2009 survey

[2] SME Access to Finance, Flash Eurobarometer 174, TNS Sofres/EOS Gallup for the European Commission, October 2005

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About Leaseurope

As a Federation, Leaseurope brings together 45 associations throughout Europe representing either the leasing, long term and/or short term automotive rental industries. The scope of products covered by Leaseurope's members ranges from hire purchase and finance leases to operating leases of all asset types (automotive, equipment and real estate) and also includes the rental of cars, vans and trucks. More information on Leaseurope and its members can be found at www.leaseurope.org.