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Article

Leasing in Europe and the review of international lease accounting

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Leasing in Europe and the Review of International Lease Accounting[◇]

Jacqueline Mills[#]

Gliederung		Seite
1.	About Leaseurope	40
2.	The European leasing market	41
3.	International lease accounting review	47
3.1	IFRS application in and adoption in the EU	47
3.2	The context behind the review	49
3.3	The likely direction of the project and its impact	51
4.	Concluding remarks	60

[◇] Festvortrag gehalten anlässlich der Jahreshauptversammlung des Forschungsinstituts für Leasing an der Universität zu Köln.

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The following text is intended to give a flavour of a speech given by Jacqueline Mills, Leaseurope, during the annual meeting of the German Leasing Research Institute.

It does not attempt to reproduce the intervention in its entirety but merely aims at providing an overview of the speech covering the European leasing business and current discussions on lease accounting at the international level at time of delivery. It does not represent a position of Leaseurope. Leaseurope cannot be held responsible for any errors in the text nor held accountable for its content. The text should not be reproduced or quoted in any form.

1. About Leaseurope

Leaseurope is a federation of 46 member associations in 34 different countries. We have a broader geographical coverage than the EU 27, and our members are local leasing associations or local automotive rental associations. They represent either equipment, real estate, automotive leasing or automotive rental in some cases. Together, the leasing associations represent about 1.500 firms around Europe who accounted for approximately 93% of the European leasing market in 2007. Therefore, Leaseurope is a highly representative federation, we really are the voice of the European leasing and automotive rental industry.

As a trade association, we represent our members' interests and views vis-a-vis stakeholders and policymakers on the European and international level. We try to make sure that the industry's voice is heard by the people who make laws in Brussels, the European Commission, Parliament and Council but also, for example, in London in the case of the IASB or in Switzerland when we are talking about capital requirements developed by the Basel Committee on Banking Supervision.

Our activities also include promoting the industry and highlighting the advantages of leasing. Furthermore, we produce European level statistics which we collect from our member associations. We also offer a platform for our members and the European leasing industry to come together and to exchange views on current issues of concern for them as well as best practices. We also organise

industry gatherings. We have an annual convention every year in a different European country where the entire European leasing industry comes together. We also hold meetings in Central and Eastern European countries and we really try to create a community of leasing in Europe.

If you want to find out more about what we do, the different policy areas we are working on including lease accounting, tax issues, prudential supervision issues, capital requirements, and a host of legal issues amongst others, please visit our website (www.leaseurope.org). You will also find details about our committee structure, the way we work and the different policy topics that we are currently addressing on our site.

2. The European leasing market

These figures are from 2007 but we will comment on the situation in 2008 towards the end. Leaseurope's statistics come from our annual enquiry on European leasing which is based on data that we collect from our member associations in all the different countries.



Fig. 1: World Leasing Markets in 2007

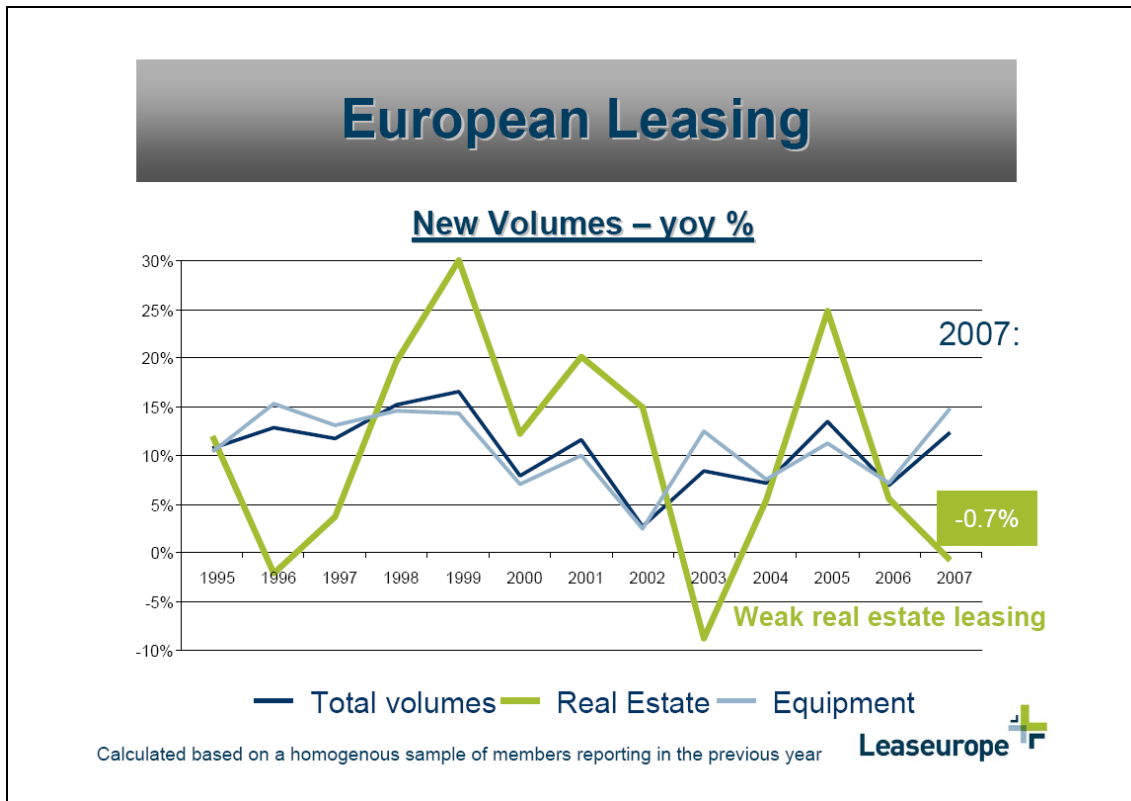


Fig. 2: New volumes in the European Leasing Markets

In 2007, the European leasing market was the largest market in the world, by far larger than that in US (see fig. 1). The lessors in Europe granted new leasing volumes of just under 340 billion EUR. If you take real estate out of that, you still have equipment, including automotive leasing, worth just under 300 billion EUR.

Figure 2 shows the growth rate of European leasing over the past more than 10 years. In 2007, the European leasing industry did very well with new volumes growing by 12,4 %. And that was actually one of the highest growth rates on record, higher than 2006. In Europe, it is perceptibly stronger than in the US (+ 4,5 %) and much better than in Japan (- 9,1 %). Now, where did this growth come from? The reason behind this very strong growth was in particular very, good growth in the equipment leasing sector, which increased by 14,8 %.

If you compare this to real estate leasing growth which is much more volatile, with proportionally fewer, larger tickets sometimes done on a more exceptional basis, the real estate leasing market in Europe actually shrunk slightly and lost almost 1 % last year. So it is really the traditional equipment leasing that was

supporting the European market, particularly in sectors such as truck leasing and machinery and equipment leasing.

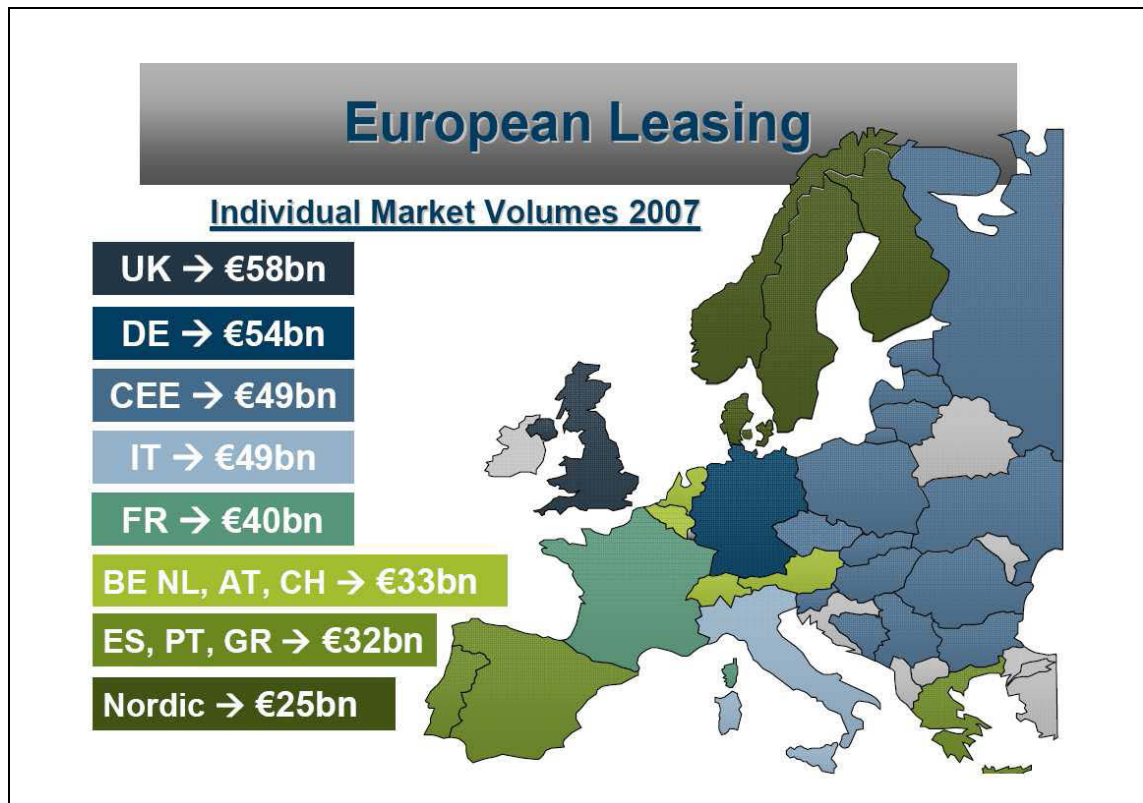


Fig. 3: Individual European Market Volumes in 2007

If we have a look at the different individual markets (see fig. 3), you can see that in 2007 the largest leasing market in Europe was the United Kingdom (UK) with new volumes of just under 60 billion EUR, second place you have Germany with volumes of about 54 billion EUR, then you have what we call the CEE cluster which is the group of all the countries in Central and Eastern Europe with volumes of about 50 billion EUR. This cluster has increased enormously in size over past years. They are now the same size together as the Italian market is on its own and the Italian market is worth just under 50 billion EUR.

Then you have France and the smaller groups of countries in Western Europe, the Northern countries and in the Mediterranean areas. And maybe one thing that has to be pointed out is that after the UK, Germany, Italy and France the next largest individual market on his own is Spain, and after Spain you have Russia, which is really becoming increasingly important and our Russian mem-

ber reported new volumes in 2007 of 14 billion EUR. These statistics are not as representative as some of our other members are, and probably the entire Russian leasing market is worth somewhere around 20 billion EUR. It is quite hard to know the exact size, but it is in that region, so it is a very important market that is growing extremely rapidly.

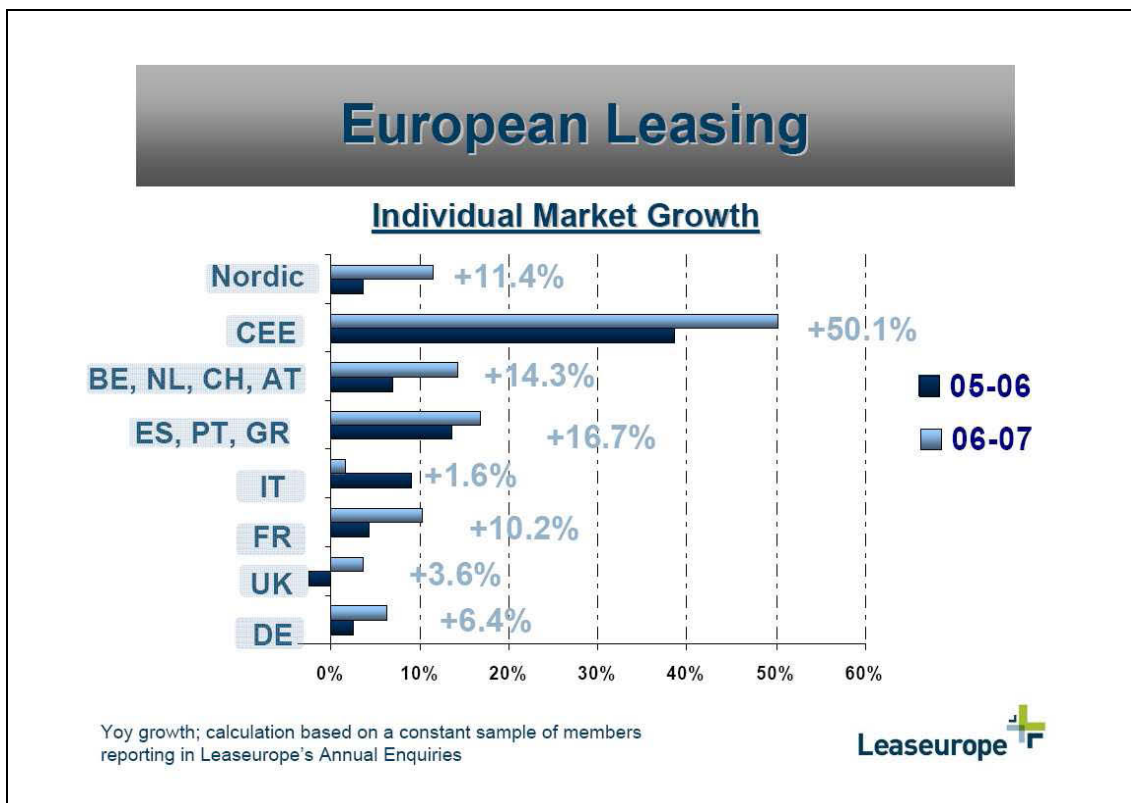


Fig. 4: Individual European Market Growth Rates

When talking about growth, you will see that the Central and Eastern European countries have been performing extremely well with outstanding growth rates (see fig. 4). Leasing has grown by just about 50 % in that region in 2007. In the other European countries, the growth was still very strong with double digit growth even in the Western, more mature markets. You have for example the Spanish, Portuguese and Greek cluster growing by just under 17 %. Nordic leasing and leasing in the Benelux countries is very strong, too. And even the large mature markets like France, Germany were doing quite well. The UK growth in 2007 is of just under 4 %. This was better than the previous year, where they had a small decline.

The market that suffered the most in 2007 was the Italian market, which is traditionally quite dynamic. But in 2007, it grew by just under 2 %. This was due mainly to falls in the Italian real estate leasing market that is very important in that country. It accounts about 50 % of their new volumes.

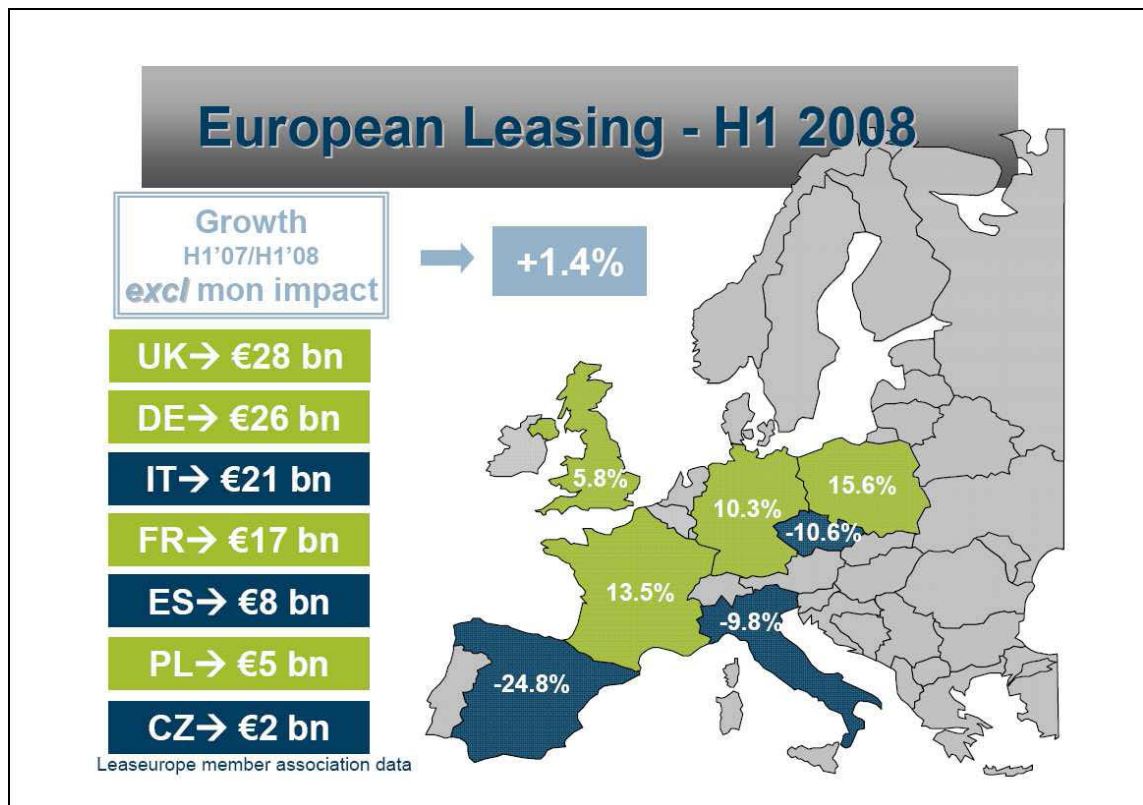


Fig. 5: Individual European Market Growth in the first half of 2008 (excl. exchange rate impact)

What about 2008? Unfortunately, Leaseurope does not have for the moment complete figures for 2008 from its members. But I did the exercise of asking a few of our member associations for their new volumes in the first half of 2008 (see fig. 5). As you can see, there are some countries with increasing leasing volumes in the first half of 2008 compared to the same period of 2007. So you have UK, Germany, France and Poland doing quite well but some other countries – Italy, Spain and the Czech Republic – that are already starting to suffer quite severely. If you take those countries together, the overall growth for the first half of the year compared to 2007 is just over 1 %.

But this result does not take into account exchange rate effects. If you exclude exchange rate effects and in particular the depreciation of the Pound against the Euro, you can see that overall growth in these countries is actually negative.

Together, these are some of the most important European leasing markets, they represent about 70 % of Leaseurope's total new business.

So, what about the end of the year? Basically, if you make some simple assumptions using the data that those members gave Leaseurope, it is possibly likely that new leasing volumes in Europe will not be as high as they were last year and may be in a region of somewhere like 320 billion EUR instead of a 340 billion EUR. That could be a 5 % decrease, if the trend is the same in the second half of the year. And of course, we all know things are more difficult now, especially since September and October.

Now is it all doom and gloom? Not necessarily. Leasing companies have some advantages compared to traditional bank loans. They are, for instance, able to benefit from lower capital requirements compared to traditional bank loans and there is a security of the asset. So there may still possibly be an opportunity for lessors to be able to provide finance for European investment.

Of course, investment figures are lower than they used to be, forecasts for investments are dropping rapidly. Every time you open the newspaper, there is a revised estimate. But still, if you consider, for example, that generally on average throughout Europe leasing finances about 30 % of investment, there is still the other 70 % of investment, even if it is decreasing, that needs to be financed.

Companies can either use their own internal funds, which will probably be under strain in the current situation and next year, or they can look for other sources of funds like bank loans. But due to the advantages of leasing mentioned above, leasing probably has a bigger advantage and might be able to take the place of some other means of finance. Therefore, even though on the absolute level leasing will probably not perform as well as it did last year, penetration of leasing might rise or at the very least not decrease.

Hopefully, the future is not just doom and gloom. For those lessors, who do have funding, who do have the money there, there may be some opportunities. We have also seen some leasing companies across Europe starting to use some of the money that has been made available by governments in the con-

text of the different banking bail outs etc. either using the funds or the guarantees to be able to actually access money now to continue to write new business.

3. International lease accounting review

With a quick reminder of how IFRS is applied in the EU, one can show you why it is important for European leasing what the IASB decides in London. The adoption process of IFRS standards in the EU is all about how IFRS become law in Europe.

3.1 IFRS application in and adoption in the EU

IFRS application is mandatory in the EU for all listed firms, banks and insurance companies on a consolidated basis. Member States also have an option to apply IFRS to non-listed firms on an individual or consolidated basis or to listed firms on an individual basis. On top of the IFRS accounting which thus mainly applies to the big companies and financial institutions, you have in each European Member State a set of local accounting standards, local Generally Accepted Accounting Principles (GAAP). In some cases, you even have big GAAP for the larger corporations and small GAAP for the small and medium-sized enterprises (SME), for example. In summary, it is a complex accounting landscape in Europe with a lot of different standards applying, depending on the size of a company.

A trend that we definitely see throughout Europe is a kind of “contagion” from IFRS standards into local GAAP. In some countries, local GAAP are basically IFRS for all intents and purposes, particularly in some of the Central and Eastern European countries where they were fortunate to be able to actually adopt IFRS as their own standards straight away. Perhaps simplified in some cases, but local standards are often very similar to the full IFRS.

One of the things I just want to draw your attention to is convergence with US-GAAP. The IASB and FASB are working on a number of projects together where they are trying to come up with converged standards, so similar account-

ing treatments would be used both on the international level and in the US. And this is particularly important as the US is very probably likely to start using IFRS in 2014 and some companies may even adopt early, possibly as soon as 2010.

So how does an IFRS Standard produced by the IASB in London become a European accounting standard (see fig. 6)? It starts with the IASB who have their own due process, including different stages, discussion papers, exposure draft standards, which already start to look like final standards. They consult with the different stakeholders and, at the end of the day, they produce a final IFRS. This gets sent in Europe to a committee called EFRAG which is the European Financial Reporting Advisory Group. They are in charge of providing endorsement advice to the European Commission.

There is another committee called the SARG which makes sure that the advice EFRAG gives the Commission is objective and well-balanced. The Commission then decides to accept EFRAG's advice or not. For the moment, the Commission has always listened to EFRAG's endorsement advice and makes the European proposal for an accounting standard. This is then sent to another committee, the ARC which is made up of Member State representatives who give the green light to the Commission to go ahead and adopt. The European Council and the Parliament then get involved and they can decide whether the Commission has respected its implementation powers and whether the accounting standard is in the spirit of IFRS, that is to say, whether it leads to accounting treatment that would present a true and fair value of a company's situation. So once this is done, at the end of the day you have an EU regulation which is directly applicable in Member States.

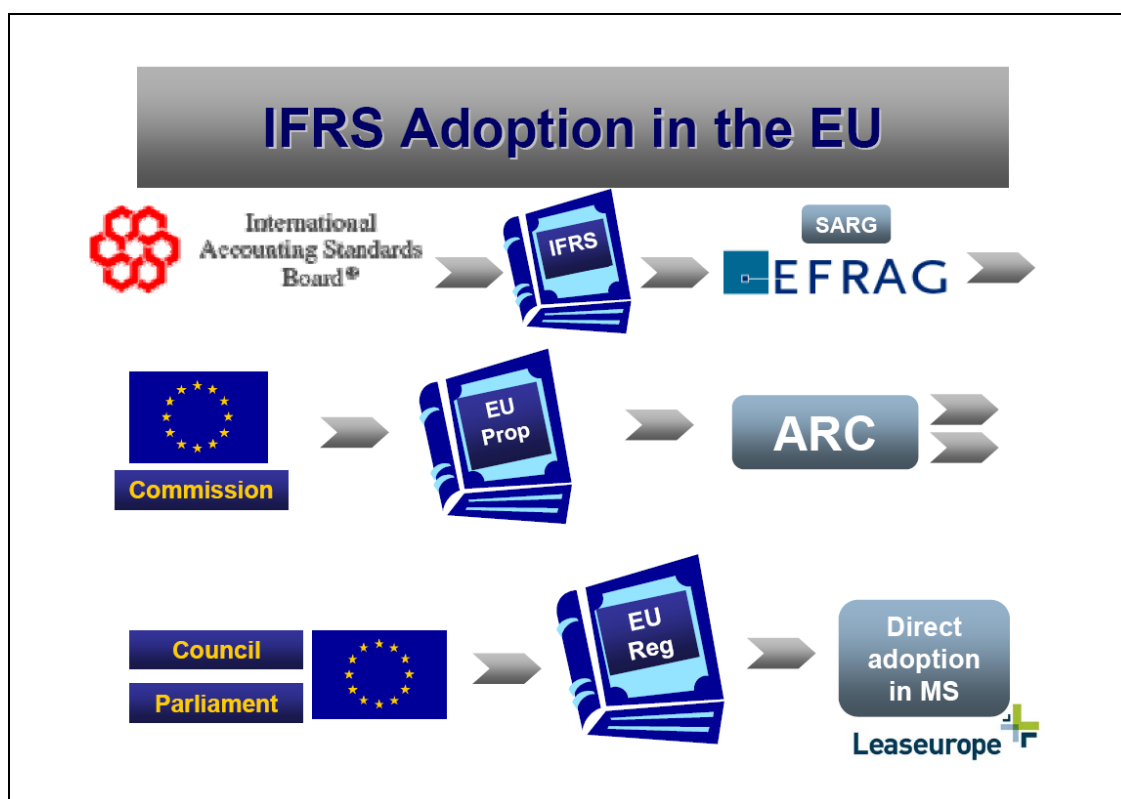


Fig. 6: IFRS Adoption Process in the EU

Summing up, there are several links in this chain where the European leasing industry can intervene to try and get our messages across. We can talk to EFRAG, we can talk to the Commission, we can talk to Member States and to Members of the European Parliament.

3.2 The context behind the review

Why did the IASB and FASB want to change today's lease accounting? The risk and rewards approach that we have today has actually been subject to a number of discussions for more than 10 years. As commonly known, in 1996 a group of G4+1 standard setters already produced a paper outlining a new approach to lease accounting. It took 10 years to put a leasing project on the IASB and FASB's active agendas and to really start doing serious work on leasing.

Why did they do this in 2006? There were a few very important reasons. First of all, in 2001 and 2002 some of the largest corporate defaults in the history – Enron and Worldcom – led US authorities to start thinking about off-balance sheet accounting in more detail. This was not leasing specific, and the review included

all kinds of off-balance sheet treatment. The result was that the SEC, the Security Exchange Commission in the US, produced a report where they recommended that the FASB together with the IASB should fully review the existing lease accounting standard.

The second reason is convergence. Here, the IASB and FASB have an opportunity to work on a new standard together and to come up with something common to both sets of standards. It is particularly important to achieve this, because the US will start using IFRS in 2014.

To date, not as much time as initially planned has been spent on the leasing project as the IASB has been concentrating on fair value accounting and issues related to the financial crisis. Nevertheless, the leases project is still very important in the sense that standard setters want an improved standard for leasing by 2011, so that when it comes to other capital markets adopting IFRS, the new accounting treatment is in place.

Standard setters make several arguments to justify why current lease accounting, the economic ownership model, has to be changed. The model of economic ownership for the moment leads to the recognition of assets and liabilities on a lessee's balance-sheet that are not consistent with the definitions that the IASB has of assets and liabilities. Basically, they say that the assets and liabilities on the lessee's balance sheet are understated. And it is very serious to have liabilities that are understated in particular.

Other issues are classification issues concerning the decision of whether or not a lease is a finance or an operating lease. They argue that this decision is difficult to perform, it could be arbitrary. It would lead to a lack of comparability. Somebody might say lease X is a finance lease when another person might treat lease X as an operating lease. You would have similar transactions being accounted for differently, depending on which side of the divide you are. You might only have to change very slight features of the contract to be able to fall into one category. Moreover, users such as investment analysts, credit rating agencies, banks, etc. often already make adjustments to take operating leasing into account.

The last point they make is that leasing is very significant. The SEC report mentioned earlier showed an estimated 1,25 trillion USD of undiscounted non-cancellable operating leases that were off-balance in the US. It is quite a significant amount. All of these arguments plus the political context that we have just been through has led them to want to change the economic approach.

3.3 The likely direction of the project and its impact

The international lease accounting review has now turned out to be a lessee accounting review. The IASB and FASB have decided that lessee accounting should be completed by June 2011. Why June 2011? The idea is to have standards that are convergence projects between IFRS and US-GAAP finished by that date so that by the time the US starts using IFRS they will have had time to get used to these new standards and there should not be any other new standards in that interim period.

This means that lessor accounting has been deferred until after June 2011. Why have they decided to do this? First of all, lessor accounting touches on other projects that they are busy dealing with like revenue recognition and de-recognition of assets. Therefore, they want to finalise those projects first before they start working on lessor accounting, because the result of those projects might impact on lessor accounting. They want to take the time to consider the differences between real estate leasing and other kinds of leasing for lessor accounting. There is a concern that if they do both lessee and lessor leasing together, they will not make it for the June 2011 deadline and they will have missed their opportunity to make improvements to lease accounting that will benefit a large number of users of accounts.

Now, Leaseurope, together with a number of international leasing industry associations strongly opposed this decision when it was made a few months ago. Leaseurope highlighted all the different drawbacks going along this route. Lessors have their own problems with lessor accounting, they would like to see it fixed as soon as possible, for example straight line depreciation of operating leases. There is also this question of uncertainty: When will lessor accounting

actually happen? How will it be affected by the revenue recognition projects? How will that all fit together? And if you are looking at leases from a rights and obligations point of view, somehow it does not make sense only to look at one side of the transaction. Those are just some of the disadvantages. It is important to understand that the IASB does realise that this approach has disadvantages, but lessee accounting is the major issue for standard setters and they have to get it done as soon as possible.

What are they going to do for lessee accounting? The latest information is a draft discussion paper that was presented to the members of international leases working group. The final discussion paper which has been postponed is probably going to be due out in February next year. But the draft discussion paper already gives a very good flavour of what the final paper will contain.

First of all, what will the scope of the lessee standard be? They have decided to leave the scope as it is today. That means it will be the same scope as IAS 17 and IFRIC 4 which is the interpretation giving advice on whether an arrangement contains a lease. Obviously, there are some disadvantages to this approach. The fundamental review promised on lease accounting is not happening, not even for lessee accounting. The question of what a lease really is has not been fully addressed. It means also that you have similar contracts being accounted for differently, for example, you are not quite sure now whether or not you have a leasing contract or a service contract. The borderline between those two is a little bit vague. There would also be strain on the current guidance whether or not you have a lease. And the IASB and FASB would need to provide additional guidance, for example, on how to split payments for services from the rest of rental payments. Would you capitalise them with the lease or not? That needs to be decided. And that could be a big issue for some lessors, particularly those who provide full service leasing in different areas.

The draft discussion paper talks about providing some kind of exemptions from the new standard for certain types of leases. For the moment, they are talking about mainly short-term – and by short-term, they say less than a year – or immaterial leases which will not provide that much relief from the standard. Leaseurope has been working on developing the concept of an exemption of

leases of non-core assets. Basically, non-core assets would be where you would have a lease of goods that are individually immaterial, fungible and importantly, they would not be part of the main production and distribution processes of the lessee. For example, we are trying here to differentiate between the airline putting its aircraft on balance and putting its photocopiers or company cars on balance.

The accounting model they are considering attempts to recognise the lessee's rights and obligations that meet their definitions of assets and liabilities. They have decided that the lessee's right to use the leased item is an asset, it meets their definition. And the lessee's obligation to make rental payments is the lessee's liability. The model, that they find fully captures and recognises these assets and liabilities, is an adapted finance lease model – similar to the finance lease model that we have today with some tricks. Basically, instead of recognising that the lessee has something similar to purchase of an asset, it would be a model that recognises that the lessee has the right to use that asset.

Regarding lease classification, would there still be a reason to differentiate between the different kinds of leases? The IASB and the FASB are currently discussing this issue. It appears that the IASB is leaning towards no classification. If you have a lease, you will always have the same assets and liabilities. You will always have the right to use and an obligation to make payments. In their opinion, there is no need to make differences between the different kinds of leases. Some members of the FASB however think that there may truly be different kinds of leases. For example, you have leases that are more like the purchase of an asset and a loan. And you have leases which are really what they call "true right-of-use" leases, where there is no intention to acquire or to purchase the asset at the end of the day. And if you accept that there are these two different kinds of leases, probably you want to treat them differently and want to account for them differently. The FASB is still deliberating on that and for the moment, the approach they have taken in the discussion paper (and this is valid for a lot of aspects of the project), is just to set up the pros and cons of both options.

Coming on to how these assets and liabilities would be measured initially at the start of the lease, the asset would equal the liability which is measured at the present value of the lease payments. That is different, for example, to what we have today - the notion of minimum lease payments. The present value of the lease payments would be discounted at the incremental secured borrowing rate. Now, there is discussion on whether to use that rate or the rate inherent in the lease. It seems that they all go for the secured borrowing rate. Additionally, the lease payments will have to include a best estimate of all the possible cash flows related to the lease even in optional periods. This notion, although not precisely fair value measurement, is something relatively close to fair value. One simplification compared to what they were originally thinking at least is that they abandoned the concept of having the fair value of right of use. What is its fair value of the lessee's right of use? Presumably, not many people know. You no longer have to think about that, you would just have to think about the present value of lease payments under this approach.

Another simplification is that they have abandoned what they called the "components approach". That means looking at the different parts of a lease separately, looking at lease payments, options – purchase options and options to extend – and valuing them and measuring them separately. Constituents warned the standard setters that this would be too complicated: nobody knows what an option to extend a lease is worth. But because the aim is to avoid lessors writing a number of very short-term leases with options to extend, for example, to reduce their asset and liability, it has been decided that options to extend or to terminate a lease should intervene in determining the lease term according to a best estimate of the lease term. That means if you have a 5-year-lease with a 3-year-option to extend, you would have to probably put something on balance that reflects the likelihood of exercising the option. They have discussed different approaches to how you would do that. Again, the IASB and FASB do not agree at this stage on how you should do that. The FASB says you should decide whether you have a 5-year-lease or an 8-year-lease after examining a number of factors that would lead you to one conclusion or the other. The IASB says you should do a probability-weighted best estimate of that. That means if you have a 50-50 % chance of exercising your option to re-

new, you would have a lease term of 6,5 years in that example, actually an impossible contractual outcome. Additionally, you may have to reassess this lease term at each reporting date.

Once you have done initial measurement, how would you measure the lease going forward through the lease term? On the liability side, there are again different views between the IASB and FASB. The IASB says that the lease payments should be proportioned between a finance charge and a reduction of the outstanding liability like it is today under finance lease accounting. The FASB has not taken a decision yet, but seems to support a linked approach where the asset and liability would have the same value throughout the contract. On the asset side, they have identified several options. You could subsequently measure the asset like you would measure the leased asset if you owned it. Depending on the nature of the leased asset, you could use IAS 16 for property, plant or equipment, or IAS 38 for intangible assets. Alternatively, you can say, a right of use is not at all like the leased asset, but it is something intangible, and then use just intangible asset accounting. Or you can say, a leased asset is something different, it is not like an intangible or like the leased asset. It is different, so it needs specific measurement. For example, this would allow you to link the asset and liability measurement together. As you make rental payments, you consume the economic benefits of the right to use and as a result the asset and liability should always be equal. There is no reason for them to be different. And then in your P&L, you can do one or two things: You can either just recognise a rental like you do under today's operating lease treatments or you can split that rental into an interest and principal component. For depreciation, the FASB has not decided yet. The IASB thinks that it should be the shorter of the lease term or economic life, except when you think title is reasonably certain to pass.

For showing what the impact on the lessee's financial accounts could be, you may have a look at the numerical example (see fig. 7). We have a computer lease with an equipment cost of EUR 4.000, 36 months lease. The lessor has a

residual of 15 %. These examples are based on an exercise of the US Equipment Leasing and Finance Association (ELFA).¹

In IAS 17 operating lease treatment as we have it today, you have no asset and no liability on the balance sheet (see fig. 8). You expense the rental each time. And if you look at the P&L in an earnings format, you have a low EBITDA and constant earnings before tax.

Approach to Lessee Accounting

□ An example:

- Computer workstation lease
- Equipment cost: 4 000€
- Term: 36 months
- Lessor's residual: 15%
- Monthly rental: 110.54
- Lessee's incremental borrowing rate: 8%
- N.B. US true lease tax treatment:
 - Monthly tax deduction is total monthly rental
 - Incremental tax rate: 40%



Fig. 7: A numerical example based on an exercise of the ELFA.

¹ They have been developed by William Bosco, Leasing101, and supplemented by Leaseurope's Accounting and Taxation Committee.

IAS 17 Operating Lease


Balance sheet	Initial	YR 1	YR 2	YR 3	
Equipment	0	0	0	0	No asset, no liability
Cap lease oblig	0	0	0	0	
Deferred tax liab	-	-	-	-	
P&L					
Rent expense		1,326	1,326	1,326	Recognise the rental as expense
Depreciation	-	0	0	0	
Interest expense	-	0	0	0	
Tax expense	-	531	531	531	
Net after tax	-	796	796	796	
P&L Earnings Format					
Income		2,000	2,000	2,000	EBITDA low, no impact on earnings Leaseurope 
EBITDA		674	674	674	
EBIT		674	674	674	
Earnings before tax		674	674	674	

Fig. 8: A numerical example – IAS 17 Operating Lease

Discussion Paper Approach



Balance sheet	Initial	YR 1	YR 2	YR 3	RoU asset & liability recognised & de-linked
Equipment	3,528	2,352	1,176	0	
Cap lease oblig	3,528	2,444	1,271	0	
Deferred tax liab	-	15	15	0	
P&L					No rental, straight line depreciation, interest charged
Rent expense	-				
Depreciation	-	1,176	1,176	1,176	
Interest expense	-	243	153	56	
Tax expense	-	568	532	493	
Net after tax	-	851	797	739	
P&L Earnings Format					EBITDA up, Earnings down Leaseurope 
Income		2,000	2,000	2,000	
EBITDA		2,000	2,000	2,000	
EBIT		824	824	824	
Earnings before tax		581	671	768	

Fig. 9: A numerical example – Discussion Paper Approach

Alternative Approach (1)

Balance sheet	Initial	YR 1	YR 2	YR 3	RoU asset & liability recognised & linked	
Right to use equip	3,528	2,444	1,271	(0)		
Cap lease oblig	3,528	2,444	1,271	(0)		
Deferred tax liab	-	-	-	-		
P&L						
Rent expense		1,326	1,326	1,326	IAS 17 Op lease P&L	Rental recognised
Depreciation	-					
Interest expense	-					
Tax expense	-	531	531	531		
Net after tax	-	796	796	796		
P&L Earnings Format						EBITDA low, no impact on earnings
Income		2,000	2,000	2,000		
EBITDA		674	674	674		
EBIT		674	674	674		
Earnings before tax		674	674	674		
Leaseurope 						

IAS 17 Op lease P&L

Fig. 10: A numerical example – Alternative Approach (1)

Alternative Approach (2)


Balance sheet	Initial	YR 1	YR 2	YR 3	RoU asset & liability recognised & linked
Right to use equip	3,528	2,444	1,271	(0)	
Cap lease oblig	3,528	2,444	1,271	(0)	
Deferred tax liab	-	-	-	-	
P&L					
Rent expense					No rental, actuarial depreciation, interest charged
Depreciation	-	1,083	1,173	1,271	
Interest expense	-	243	153	56	
Tax expense	-	531	531	531	
Net after tax	-	796	796	796	
P&L Earnings Format					
Income		2,000	2,000	2,000	EBITDA up, no impact on earnings Leaseurope 
EBITDA		2,000	2,000	2,000	
EBIT		917	827	729	
Earnings before tax		674	674	674	

Fig. 11: A numerical example – Alternative Approach (2)

If we take the approach that they are considering in the draft discussion paper, you have a right of use asset and a liability, which are recognised on the balance sheet (see fig. 9). As you can see, the values differ throughout the lease term - they are not linked. You do not recognise a rental, but you would probably use straight-line depreciation of your asset and have an interest charge. If you look at the P&L in an earnings presentation, your EBITDA suddenly rises dramatically compared to the previous example, because you are no longer recognising that rental. Additionally, your earnings are down. There are higher costs particularly in the earlier years of the lease. And the longer the lease would be, the higher this impact would be.

What are some alternatives to this approach? You could still recognise something on balance, but it would be much better to recognise that, as a lease is different to a loan and is really a package of a liability and an asset (see fig. 10), the asset and liability should be measured at the same values over time. By doing this, you would have equal values of the asset and liability on your balance sheet and in the P&L, you could recognise a rental.

Another alternative would be to have the same balance sheet, but instead of recognising a rental expense, you would use actuarial depreciation of the asset instead of straight line depreciation and show an interest charge (see fig. 11). The advantage of this would be there is no impact on your earnings at the end of the day.

In the draft discussion paper, standard setters have also examined how to take into account contingent rentals. Contrary to today's treatment, these should be recognised. If these are not recognised, the concern is that lessors would write leases with based entirely on contingent rents and nothing would be put on balance sheet that way. The reasoning behind recognition of contingent rents is that although the amount itself is not known today and is conditional on your contingency actually happening, if it does arise, then you have an unconditional obligation which means you have a liability and you should account for it.

You would use again a best estimate of lease payments which includes your contingent rents. And on every reporting date you may also have to think, what

is my best estimate of my contingent rentals and record changes if necessary. As you can see, that is likely to be an extremely complicated process.

Purchase options and residual value guarantees still have to be discussed in more detail, but it is very likely that they are going to be treated in a similar way.

There are some other issues that still need to be clarified. Some are being discussed currently and some will be discussed in other meetings before the discussion paper comes out. Standard setters still need to talk about timing, i.e. when you recognise these assets and liabilities. For Leaseurope, presentation is also a big issue that must be addressed, as it is very important to distinguish between leases and loans, leases and other kinds of assets. Leases probably should have their own specific balance sheet line. Moreover, because of their decision to separate lessee and lessor accounting, standard setters have problems with subleases, i.e. cases when a lessee is also a lessor of the same asset. They need to provide help for those companies on how to deal with those situations. Another unanswered question is the treatment of initial direct costs – do you capitalise them or do you expense them? Moreover, how do you treat sale & leaseback transactions? And what do you do with disclosure? You probably have to explain how you came up with your best estimates at the very least.

4. Concluding remarks

What does this all mean for leasing? Will putting leasing on balance stop people leasing? If the only reason that somebody leases is to get off balance sheet treatment, then there is probably a problem. But leasing exists as a product for a whole number of reasons. There are a lot of other advantages to use leasing apart from the off balance sheet treatment. People who evaluate lessee financial statements are probably in any case already adjusting for this off-balance sheet treatment. They will already have taken that into account when making their decisions. Therefore, putting leasing on balance should in theory not make such a big difference. It is possibly the P&L impacts that are much more important than the balance sheet impacts. The EBITDA measures will rise, earnings

will fall, because costs will have increased. And the longer the lease is, the more important the increase in costs will be. For example, for a ten-year lease, you have a 60% increase in costs over the first five years of a lease under the possibly new system.

But probably the most difficult thing of what the IASB and FASB are thinking about is the level of complexity of their approach. It is extremely difficult to manage. Particularly, if you are a small company, why would you spend time calculating all these complicated best estimates when it could be very much easier for you just to buy the asset or try to get a loan for the asset in which case the accounting would be easier? It is also questionable whether this de-linked approach to subsequent measurement provides better information. Does it truly better explain the lessee's economic and financial situation to people who read accounts? Probably not, it may just make the accounts more confused and unclear. Best estimates, reassessing these best estimates at each reporting date – also an extremely high compliance burden. A combination of all these factors may lead companies to questioning whether it is still worthwhile to lease, even though the lease may actually be a good solution for them and have real economic benefits. What we really need is not an approach that is about off-balance or on-balance, but something that takes into account the specificities of the leasing product and does not produce a too high cost preparation burden for the people who actually need to sit down and do the accounting.

If you want to learn more or help Leaseurope in their work and do contribute to their work, you can visit the website (www.leaseurope.org) or you can ask for the passwords for a lease accounting blog that they have created. It is restricted to European lessors. There you have all different kinds of information resources on the lease accounting project and you can see the positions, too.

Leaseurope gathers industry positions from our member association's positions, for example the BDL in Germany. The more feedback and contributions that we have from the industry, the better quality position we can build to help the standard setters get lease accounting right.

Leaseurope will provide a European industry reaction to the discussion paper which we expect in February 2009. It is also very important to work with local standard setters. And the BDL has contacts with the local standard setters. There is a mirror leases working group that has been set up in Germany. Local standard setters are particularly important when it comes to the information and feedback they can give to EFRAG as they give advice to the Commission whether or not to adopt standards.

And lastly and very importantly, you should talk to your customers and see what they think what the impact is going to be. This has now become to a lessee issue. And it is also important for us as the European leasing industry to be able to hear the views of lessees and to help us to present those views to the standard setters.