Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Leaseurope Response to the Leases Discussion Paper

Leaseurope, the trade association representing leasing and automotive rental in Europe, very much welcomes the joint IASB/FASB Discussion Paper: Leases – Preliminary Views as an opportunity to provide input to standard setters on the direction of future lease accounting standards.

An executive summary precedes our comment letter, which is structured as follows.

The first section introduces the European leasing market as represented by Leaseurope and describes the reasons why businesses use leasing.

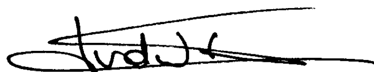
The second section comments on the process for developing a new lease accounting model. It discusses the current model and underlines the need for standard setters to make a clear case for change before departing entirely from this approach. In particular, the amount of operating leases in the financial statements of IFRS preparers needs to be quantified and particular "problem areas" identified before further work is conducted. The section also addresses the need for a cost/benefit of any new model to be conducted early on in the standard setting process and underlines the necessity for due process to be respected with regards to lessor accounting in particular.

The third section contains our responses to the individual questions of the Discussion Paper. Here, we have indicated our preferred approach for dealing with lease accounting but have also attempted to provide feedback to the Boards on the questions addressed to constituents even where we do not support the suggested approach. We hope in this way to provide the IASB and FASB with a constructive contribution to the leases project. However, we would stress that these comments (as well as all others) should not be taken out of their context.

The last section of the letter provides our views on a future lessor accounting model.

We have very much appreciated the willingness of the IASB Board members and Staff we have met to exchange views with the industry during the comment period to the Discussion Paper and remain committed to working closely with the Boards and their Staff going forward.

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



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Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Leaseurope Response to the Leases Discussion Paper

EXECUTIVE SUMMARY

Leasing is a vital source of funds for the European economy

Leasing is a key source of finance for European businesses. In 2007, the European leasing industry financed around 20% of all new European investments. Moreover, it has been estimated that more than half of Europe's SMEs have made use of leasing or rental. Leasing also provides companies with the means to simply and effectively outsource asset-related needs and costs. The service elements that accompany many leases can often be the decisive factor for companies choosing a contract that takes on the form of a lease above other products.

Standard setters must make an adequate case for change

While it is often said that existing lease accounting is broken, no attempt has been made to analyse the extent and nature of the use of leases by preparers reporting under IFRS. Not all leases are operating leases. Of those that are, the vast majority are straightforward leases for small items such as cars, photocopiers, IT or telecom equipment. These are very far removed from the big ticket or structured leases that are the focus of standard setters' concerns. The Discussion Paper therefore does not provide sufficient justification for entirely reviewing the current lease accounting model.

The logical place to start the standard setting process would be to carry out this analysis. Only once this has been done will standard setters be able to demonstrate 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.

Basing the creation of a new model for lease accounting on the premise that companies use leasing solely as a structuring tool is wrong and will result in a standard that will not be appropriate for the vast majority of firms who choose to lease as it is an effective and flexible solution for obtaining the use of an asset without in many cases bearing the asset's risk.

Complexity of the proposed model

Leaseurope's major concern with the right of use model proposed in the Discussion Paper 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 debate and of users' concerns, who will be the hardest hit.

Examples of complexity range from requiring firms to account for assets where today they have operating expenses, to imposing significant burdens on businesses to estimate service components, calculate incremental borrowing rates, define probabilities related to their lease terms and reassess all of these at each reporting date. Businesses opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. However, under the proposed model, in the future these companies will be required to account for their leases in a way that destroys that simplicity.

A cost/benefit analysis must be conducted before an exposure draft

Whether taken together or in isolation, the complexities and resulting costs noted above may discourage the use of leasing going forward. 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.

An extensive cost/benefit analysis is therefore a sine qua non condition before moving forward in the standard setting process. This analysis must factor in the costs for preparers, including other consequences such as impacts on regulatory capital, together with user requirements. It is unlikely that a single, difficult-to-interpret number on the balance sheet will provide users with better information.

Discussions on the scope of the leases standard cannot be avoided

Standard setters have not discussed what a lease or a right to use actually is. This will lead to significant difficulties in producing an effective and workable standard. There are also many issues with the scope of today's standard that will need to be resolved going forward. We would encourage standard setters to consider all of these issues and to factor them into their cost/benefit analysis to find the correct balance between any new standard's scope and its complexity.

Leaseurope's views on a new model for lessee accounting

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

We consider that the single asset and liability approach described in the discussion paper is neither conceptually sound nor a practicable model. We would recommend that, if, and only if, an adequate case is made showing the current model requires substantial revision for all leases, the right of use model should include only committed lease payments. In our view this would be 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.

Lessor accounting should not be neglected

The Boards' decision to postpone lessor accounting is suboptimal for the many lessees who are simultaneously lessors as well as for sublease transactions. However, in spite of the decision to defer lessor accounting, the Discussion Paper contains a chapter on lessor accounting. This chapter does not include any indication on the direction lessor accounting would follow and therefore should not be taken as implying that lessor accounting has been duly considered by the Boards.

Since publishing the Discussion Paper, the IASB and FASB have been working on a lessor accounting model. In May 2009, the IASB took tentative decisions on a lessor model that fundamentally contradict the basis for the lessee accounting model set out in the Discussion Paper. This lessor model also has significant implications for leasing firms and is likely to result in many businesses no longer being in a position to provide leasing. The European economy will thus be deprived of a vital source of funds if this model goes forward.

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 and whether any lessor accounting model that may be included in an exposure draft phase would be conceptually correct or practicable.

Leaseurope Response to the Leases Discussion Paper

COMMENT LETTER

Section I. INTRODUCTION – LEASING IN EUROPE

The European leasing market

In 2007, European leasing companies represented through the 48 member associations of Leaseurope granted new leasing volumes worth in excess of EUR 340 billion, making the European leasing market the largest in the world. These leases were used to finance equipment, vehicles and real estate throughout Europe and Leaseurope estimates that in 2007, the European leasing industry financed around 20% of all new European investments and slightly under 30% of investment in moveable assets. Of the EUR 340 billion new leases granted in 2007, approximately 86% were granted to finance various types of equipment and vehicles, with automotive leases making up almost 50% of all new business. The portfolio of leased assets in the hands of European leasing companies represented via Leaseurope's members amounted to more than EUR 713 billion at the end of 2007.

These figures clearly show that leasing makes a considerable contribution to the European economy by providing businesses with a means of finance for 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. One survey estimates 51% of all SMEs have made use of leasing or rental[1].

Why do businesses lease?

Businesses choose to lease for the following reasons:

- Leasing provides them with the possibility to finance up to 100% of the purchase price of an asset without having to offer any supplementary guarantees
- They can better manage their working capital by spreading payments over the life of the asset
- Budgeting exercises are made easier as lease payments are regular and often for a fixed amount
- Leasing gives firms the opportunity to renew their assets, thereby ensuring that they can benefit from the latest available technologies and remain competitive

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

- Lessees can use the leased equipment without having to worry about considerations linked to ownership, such as residual value risk or the disposal of the asset when it is no longer used.
- Leases are often accompanied by a range of optional services, including the insurance and maintenance of the leased asset. In this sense, a lease embodies an efficiently priced contract where all asset-related requirements can be outsourced to the lessor
- Leasing is easy to set up. It provides simplicity and process optimisation to the lessee who does not have to deal with accounting issues related to subsequent measurement of the asset such as impairment or perform reconciliation with its fixed asset register
- In some jurisdictions, taking on a lease will enable the lessee to benefit from investment incentives that the lessor can reflect through its pricing which it might not otherwise be able to benefit from

These economic advantages of leasing are valid regardless of a company's size or nature and any type of firm may choose leasing over other forms of finance for one or more of the above reasons. What is important to understand is that in the vast majority of cases, lessees are not trying to obtain a form of off-balance sheet financing by opting to lease. Instead, they are choosing to lease simply to benefit from one or several of the commercial benefits described above. Moreover, in some cases, leasing can be the only source of funds available to a firm as lessors are able to step in when other types of lenders cannot (e.g. in start-up situations). This is because lessors remain owners of the leased asset throughout the lease contract and thus benefit from a very high degree of security.

Section II. THE STANDARD SETTING PROCESS FOR LEASE ACCOUNTING

Changes to current lease accounting models

The current international standard for leases, IAS 17, distinguishes between finance leases, where the leased asset is shown on the balance sheet in a similar way to owned assets, and operating leases which are not included on the balance sheet but where details are reflected in the notes to the financial statements.

With the publication of the Leases Discussion Paper (the Discussion Paper or DP), the IASB and FASB (the Boards) aim to address concerns of users of financial statements regarding the existing model for lease accounting described above. Users take the view that "financial statements do not depict clearly the effects of operating leases"[2] and consequently they make adjustments to take operating leases into account. The Discussion Paper therefore sets out the Boards' preliminary views on the future direction of a new standard for lessees.

[2] Snapshot: Leases – Preliminary Views, IASB

Standard setters must make a case for change

Leaseurope believes that before any further work is done to develop a new lease accounting model, standard setters must prove that the existing model for leases is effectively broken and identify those areas where it is the weakest.

While there has been some attempt in the US to quantify the amount of off balance sheet commitments under operating leases, for instance the 2005 SEC report[3], to our knowledge, there has been no similar attempt to quantify the amount of operating leases of European businesses reporting under IFRS. Therefore, we strongly believe that the IASB needs to make a case to prove that the extent of the issue is as significant under IFRS as it is under US GAAP. We would also encourage the Board not to jump to such conclusions or make public statements regarding the extent of operating leases under IFRS without having conducted such preliminary ground work.

We would also like to point out that the US Equipment Leasing and Finance Association estimates that the vast majority (in excess of 75% of the USD amount) of the leases identified in the above mentioned SEC report are leases of real estate. This begs the question of whether it is reasonable to completely revise lease accounting for all types of assets without further exploring where the real difficulties with today's approach lie.

For instance, standard setters refer frequently to aircraft leases as being a problem. However, the vast majority of leases are plain vanilla transactions that cover the small- to mid-ticket markets and are in fact very different to the structured, big ticket leases that appear to be at the core of the issue. For instance, the global airline fleet is made up of some 20,000 aircraft, of which approximately one third are leased (and not all of these leases are operating leases). Yet, the top 100 European leasing firms alone write around 5 million individual lease contracts in one year. These are leases that are mostly used to finance what can be referred to as "straightforward assets" such as cars, vans, trucks, machinery, PCs and photocopiers and can hardly be described as structured deals.

In other words, Leaseurope is of the opinion that before undertaking a complete revision of IAS 17, the IASB must perform an analysis of the extent of operating leases in the accounts of IFRS preparers, including an identification of the types of assets that are leased in this way and in which sectors they are most common. This is a necessary condition to be able to evaluate the effectiveness of the existing model and to design a new model if need be. 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), standard setters should focus their efforts 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.

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[3] Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

Not all leases are the same, in particular, property leasing can be very different to equipment leasing

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

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

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

Timeliness of reviewing lease accounting

Given the significant number of ongoing projects and current developments, including the financial crisis that has lead to the Boards 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 Boards, 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 obvious 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, the Boards should 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. There is a very real risk that a completely revised approach will be rushed and ill thought out.

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A cost/benefit analysis must be conducted before an exposure draft

If a case is made that current IFRS lease accounting needs to be revised in the short term, it is essential that a cost/benefit 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 principles announced in the Discussion Paper. This analysis will help standard setters define a new model in a way that is proportionate and will effectively tackle areas where the existing standard may be weakest.

As Leaseurope, our major concern is that the right of use model proposed in the DP will create excessive complexity and burdens for preparers. Although firms with high value leases will not be immune to this complexity, it will be those companies who have many small ticket leases, very far removed from the structured, high value transactions that are at the core of the leases debate, who will be the hardest hit.

While this concern is developed throughout our response, we think it is useful to briefly summarise the types of complexity that lessees will face under the new approach:

- Firms will be faced with complex judgement calls when determining whether they have a lease contract or a service contract.
- 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.
- Businesses will have to analyse the service components that are part of lease contracts. Currently, one of the major benefits of a lease is that lessees do not have to consider such aspects. Instead they receive a single invoice encompassing all the costs related to the use of the asset.
- Lessees opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. However, in the future they will be required to account for their leases in a way that destroys this simplicity.
- 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. This is true for companies of all sizes and is a particular problem when it comes to those firms who have many small leases that will need to be dealt with in this way.
- Requiring reassessments of these estimates at each reporting date will lead to even more costs for lessees.
- It should be noted that whilst firms may be able to manage some of the complexities noted above at the level of a single lease contract, a much more significant form of complexity arises in the organisational process required in entities to collate, verify, assemble and present reporting on the many small ticket leases that are managed in varying locations around the company. These leases will all be different from one another and in many cases cannot be aggregated and dealt with in “batches”.

Equally, standard setters should be aware of other consequences of the new model. For example, as lessees will have more assets on their balance sheets under the new approach, they may need to hold additional capital for these assets. Given the current economic climate and the fact that capital is in short supply, the impact of the proposed changes on business activities is likely to be significant.

The IASB has clearly acknowledged the need for standard setters and prudential regulators to coordinate their efforts[4] and we would encourage them to examine together the impacts on the capital ratios for lessees operating in the banking industry. Depending on how right of use assets are classified, banks will have to hold 8% capital for lease related assets if they are tangible assets or deduct them from own funds if they are intangible assets. Banks are amongst some of the most important users of leasing and many financial institutions for instance lease the premises of their banking branch networks. The effects on their capital ratios will therefore be extremely important.

Whether taken together or in isolation, the complexities and resulting costs noted above are very likely to discourage the use of leasing going forward. To avoid that accounting for leases becomes so complex that businesses will be deprived of a product that has true economic value, an extensive cost/benefit analysis, factoring in the above elements is a necessary step before moving forward in the standard setting process, 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[5]. Particularly in the current climate where businesses are struggling to find ways and means to finance and use assets, it is crucial that this significant source of funding is not jeopardised.

The Discussion Paper focuses almost exclusively on lessee accounting issues

When deciding to undertake a leasing project in 2006, the Boards recognised the need to fully reconsider all aspects of lease accounting, including both lessee and lessor accounting issues. The importance of consulting stakeholders from the early stages of the project was equally acknowledged through the creation of a joint IASB/FASB working group comprised of individuals with significant experience and expertise in this field to assist the Boards and Staff in their work.

In July 2008 however, the Boards decided to defer lessor accounting and to focus on lessee accounting only, thus revising the initial project objective of reconsidering all aspects of lease accounting. Leaseurope understands that this decision was taken due to the Boards' resource constraints and the need to achieve a new (lessee) standard by the June 2011 deadline for IASB/FASB convergence projects.

[4] See for instance Sir David Tweedie's address to the Ecofin Council of 9 June 2009
[5] European Commission's Contribution to the IASCF Constitution Review, 22 June 2009

As the decision to postpone lessor accounting leads to a number of significant issues, particularly for the many firms who are simultaneously lessees and lessors (several models for lease accounting would co-exist for an unknown period of time). Leaseurope, along with a number of other associations representing the leasing industry across the globe, were very much opposed to this development.

The approach adopted by the Boards in the DP is to analyse the rights and obligations that arise under a lease. This can only be done effectively if one considers the transaction from the point of view of all parties, including the rights and obligations of lessors. If the analysis is performed solely from the lessee side, there is a very real risk that this could lead to inconsistencies when lessor aspects are considered[6]. The decision to split lessee and lessor accounting is therefore far from ideal.

Nevertheless, in the run up to the publication of the DP, the FASB in particular appeared to call in doubt the previous decision to split lessee and lessor accounting and the paper published on 19 March does contain a chapter on lessor accounting. Yet this chapter does not present any analysis, preliminary views or indications on the direction lessor accounting would take. Instead it simply contains a “high level discussion” of some lessor issues and requests constituents’ feedback.

Standard setters must respect due process

Given the content of the DP’s chapter on lessor accounting and the fact that the IASB in particular did not publicly deliberate any of these issues prior to publication of the DP, 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 Boards.

Moreover, at this point in time, it is highly uncertain as to how the Boards will proceed with respect to lessor accounting. Since the publication of the DP work on lessor accounting has been undertaken behind the scenes and the Boards have actually made tentative decisions on a lessor accounting model. There is therefore a distinct possibility that a lessor accounting model may be included in an exposure draft phase without any preliminary public consultation in the form of a discussion paper.

Lessor accounting is an extremely complex issue with major ramifications for leasing firms. The Boards’ tentative decisions for lessors, which are discussed in detail further on in our response, are significantly flawed and are likely to have severe consequences on lessors’ ability to make leasing available, thereby significantly restricting businesses’ access to this important source of funds.

It is therefore essential that lessor accounting is fully analysed and deliberated by the Boards, that their constituents are appropriately consulted and that the same due process steps that have been followed for lessee accounting apply to lessor accounting.

[6] See page 22 (response to question 3 of the Discussion Paper) for further information

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 Boards will not have fully respected their original due process commitments with the very possible consequence of the Boards not achieving an improved, high quality financial reporting standard for leasing.

Although the European leasing industry maintains that it would be preferable to consider the leases issue in its entirety as originally announced, the addition of a poor quality, quick-fix for lessor accounting to the future lessee standard examined in the Discussion Paper would not be a viable solution.

We also wish to comment on the use of the Leases Working Group. The creation of this group at the start of the leases project was very much welcomed by Leaseurope as a signal of the Board's willingness to engage with stakeholders to improve financial reporting for leases. However, it is now apparent that its functioning has not been effective. In particular we note that the group has not been involved in any discussions relating to lessor accounting. This is clearly a missed opportunity and we would encourage the Boards to make better use of the group going forward

Section III. RESPONSES TO THE DP QUESTIONS

CHAPTER 1 - BACKGROUND

The first chapter of the discussion paper summarises the criticisms of the existing model for lease accounting, IAS 17. In order to provide an exhaustive and constructive contribution to the leases debate, before responding to the individual questions in the subsequent chapters of the paper, we would like to comment on some of these issues.

Users make adjustments to lessee financial statements

One of the main criticisms of the current approach is that users have expressed the view that the current standard does not meet their needs. For example, they have to make adjustments to take into account leases that are currently not capitalised.

Leaseurope wishes to point out that the notes are an integral part of financial statements and the level of information provided in the notes should not be underestimated. The fact that users do make such adjustments using information contained in the notes is not necessarily reason enough to devise an entirely new approach to lease accounting. Instead, the Boards could have decided to improve current disclosure as an effective alternative, particularly given their time and resource constraints described above.

Recognising assets and liabilities under leases

It has also been said that the current standard does not reflect the assets and liabilities that a lessee has under a lease. It can be argued that the existing standard, based on an analysis of whether the lease transfers the risks and rewards of the leased item to the lessee, does adequately capture cases where the lessee truly has an asset and liability for the leased item as a result of the lease contract. This is because IAS 17, contrary to US GAAP where lease classification is made according to bright lines, uses a principles-based approach to determining whether a lease is a finance lease or an operating lease. While it has been argued that when applying IAS 17 preparers and auditors will often refer to US GAAP bright lines, which can lead to structuring, Leaseurope believes that this is not a flaw with the existing model *per se* but rather a failure to implement the standard appropriately. It is not reasonable to accuse IAS 17 of problems that arise with US standards.

It is critical that the Boards understand firms' motivations for leasing. Businesses will choose to 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. This use of lease documentation can be likened to a form of outsourcing where the lessee acquires a service from the lessor who takes care of all its asset related needs. Such service contracts do not give rise to assets and liabilities for the lessee.

The existing model for lease accounting recognises that there are these differences whereas under the new approach there will no longer be any form of differentiation. However, the Boards should be careful not to infer that it is because of accounting that there are different leases. On the contrary, today's model is an attempt to try and capture the true differences between leases. Nevertheless, by deciding to postpone discussions on the scope of a new standard, the Boards have not held any real discussions on what a lease actually is, nor whether there are different kinds of leases. This appears to be a flaw in the DP's proposals and will be referred to further in our comments on scope below.

In summary, we believe that further consideration should be given as to the existence of different types of leases and whether these always do create the assets and liabilities indentified by the Boards.

Structuring opportunities

The discussion paper also notes that the existing standard provides opportunities to structure a transaction to achieve a particular lease classification. However, within Europe at least, there is little evidence of this. While structuring may arise when a standard is based on a bright line, since 2005 when IFRS became applicable in Europe for listed firms on a consolidated level, firms have been obliged to consider their leases using a substance over form approach and it has become increasingly difficult to justify keeping a lease off the balance sheet if the lessee does in fact bear the risks and rewards associated with the leased item.

Consequently, the vast majority of those leases that are classified as operating leases today are not the result of a structured transaction but are true "rental" contracts where the lessee is simply outsourcing its operating asset needs to the lessor. Examples of such contract include vehicle contract hire and IT leasing, to name but a few. Based on the content of the DP, it appears that the Boards have not fully understood these businesses and the particular features of such contracts.

Complexity of today's standard

The existing standard is also accused of being complex. Nevertheless, the only real element of complexity with today's IAS17 lies in the classification decision. The rest of the standard is clear and well understood internationally.

The new approach set out in the DP proposes to do away with any form of lease classification. However, while preparers will no longer be required to decide whether they have a finance lease or an operating lease, the new approach will bring about immense complexity in many other areas as described above. Therefore, the new approach will in fact not be easier to apply at all.

Conceptual flaws of the existing model

The Discussion Paper also describes conceptual flaws with the existing model for leases. One of these flaws is that there are valuable rights and obligations that are not recognised if a lease is classified as an operating lease. This may be the case when a lease has been deliberately structured to achieve classification as an operating lease. However, as mentioned above, the Boards should be aware that this is not the case for a majority of leases and that existing international accounting standards will adequately capture those cases when the lessee does in fact have a valuable right and obligation. As explained above, a significant portion of today's operating leases are entered into by lessees as a type of service contract which provides them with the level of flexibility they require. In these cases, it is less obvious that the lessee has actually obtained rights and obligations that meet the definitions of an asset and liability.

The DP also notes that there is currently inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not. While it is not entirely clear to what this refers to, we understand that it could relate for instance to the fact that the Boards consider the lessee's obligation to pay rentals as being a financial liability yet it is outside the scope of current literature on financial liabilities. Differences of this nature are not likely to be entirely solved under the new approach. For example, even though the obligation to pay rentals is considered to be a financial liability, several aspects of the proposals (e.g. requiring remeasurement of the discount rate and the single asset and liability approach) will lead to such inconsistencies remaining in the future standard.

Conclusion

In conclusion, Leaseurope takes the view that the brief DP analysis of today's lease accounting model does not in itself provide a sufficient justification for entirely reviewing the existing lease accounting model. Further work needs to be conducted, as described in Section 1 of this response.

CHAPTER 2 – SCOPE OF LEASE ACCOUNTING STANDARD

Q1. The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

When designing a new standard, Leaseurope considers that the logical first step would have been to clearly establish what a lease is and what the scope of the new standard should be, particularly as there are a number of disadvantages to retaining current scope requirements. In the following paragraphs, we therefore describe these disadvantages, identify the impact they will have on future lease accounting and, where appropriate, highlight areas where improvements will need to be made.

The discussion paper lists the following disadvantages to basing the scope of the new standard on that of existing standards (summarised):

- Scope of IFRIC 4 may lead to some contracts being incorrectly qualified as leases
- Similar contracts may be accounted for in very different ways
- Contracts may be structured in such a way that they qualify as service contracts and not leases
- Additional guidance on how to distinguish service payments from other payments for the right to use the leased item may be required

Given the significant number and extent of these disadvantages, it is difficult to understand why the Boards reached the conclusion they did, other than for reasons of expediency. However, if there is a need to review current lease accounting, and we believe that this case still needs to be made (see above), the standard setting process should not be governed by pressure to reach an extremely tight deadline at the expense of duly considering the fundamental questions of what is a lease and dealing with the issues listed above. Otherwise, the Boards run the risk of producing a new standard that may very well create new and greater difficulties than those preparers and users face under current literature.

A converged leases standard will require alignment of the scope of today's US GAAP and IFRS standards.

As pointed out in the DP, the Boards will need to reconcile the scope of the international and US leasing standards. The two main areas of difference of these standards are around leases of investment property and intangible assets.

Leases of intangibles should be in the scope of the new standard

Very importantly, the Boards need to clarify whether leases of intangibles are within the scope of the new standard. Leaseurope does not see any reason to exclude leases of software, trademarks, etc. from the scope. As there is no specific guidance for software leasing for instance in IFRS, preparers are likely to turn to the leases standard in any event, given the IFRS hierarchy. Leasing of intangibles such as software leasing is becoming an increasingly important business and this has been recognised for instance in the drafting of Unidroit, the international model leasing law, which covers leases of intellectual property including software. We also do not see any justification for maintaining an exclusion of the licensing agreements currently listed in IAS 17.

As the new leases standard is likely to apply *de facto* to leases of intangibles (unless the Boards decide that a specific standard for intangible leasing is required), the Boards should consider whether there are any instances where the new approach will not work for such leases and decide how these contracts should be dealt with. Unless this analysis leads to some specific issues, in our opinion the new leases standard should explicitly include leases of all intangible assets.

Are all rights to use leases?

Moreover, it is difficult to see where one would draw the line between different rights to use that are leases and those that may not be. For instance, one may argue that contracts between football clubs and their players meet the definition of a lease as the football club has the right to use a specific asset in such cases. A possible extension of this example is that an employment contract could also meet the definition of a lease.

Differentiating between leases and service contracts

One of the main issues with the Boards' chosen approach to scope lies in having to differentiate between what is a lease and what is a service contract. While the Boards wish to remove the "dividing line" between finance and operating leases, under the new approach this line will simply shift to preparers having to determine whether a contract is a lease or a service. It is very likely that firms seeking to achieve a certain form of financial statement presentation will design arrangements that will not meet the definition of a lease in the future standard. This will result in little, if any, improvement compared to the current situation.

Under the new model for leases proposed in the discussion paper, the difference between operating leases and other executory, service or maintenance contracts will become much more important than it has been in the past. This is because an operating lease and a service contract currently have much the same accounting treatment, that is to say they are accounted for in profit or loss (with operating leases requiring additional disclosures). However, in the future, the accounting treatment for these types of contracts will diverge significantly. Lessees will therefore refer to IFRIC 4 much more frequently than they have in the past. As IFRIC 4 is not particularly clear or easy to use it would need to be clarified in any new standard as a matter of urgency.

IFRIC 4 requires significant clarification

The following paragraphs describe some of the difficulties with IFRIC 4 that will need to be resolved for any new standard to be workable. Given that these are significant, the Boards should not underestimate the work that will need to be carried out to address these issues.

If IFRIC 4 is not clarified, contracts that are not leases, or that are not commonly considered to be leases today, may fall under the scope of the new standard. Examples of contracts that convey a right to use an asset are:

- The acquisition by a firm of the right to use a brand or trademark (e.g. franchising, fashion industry, etc.)
- Contracts entered into by firms to ensure they are guaranteed a number of nights in a specific hotel or a certain number of seats on a flight route
- Outsourcing contracts for IT departments

Today, many people do not view these types of contracts as leases and most of these would typically be accounted for as service contracts; however, their future accounting treatment would be uncertain as they may qualify as leases going forward.

Generally speaking, we consider that the highest degree of strain on IFRIC 4 will be around determining what the asset is that is being leased, whether the asset is "specific" or not and in some cases, establishing whether the lessee has an exclusive right to use the asset in question.

In so-called capacity-type leases for instance, determining precisely what the asset is that is being leased can be far from straightforward. Consider for instance an entity looking to store goods in a warehouse. Is the asset being used the warehouse or is it a particular space in the building? Does the entity have an exclusive right to its storage space (whatever that may be) or can goods belonging to any firm be stocked in that space? Consider also the following technology examples. A satellite may have hundreds of different nodes used by various customers. Does one customer have the exclusive right to use a node or can it be given any node that is available at the time? Is the asset being used the node or the satellite? Should this make a difference in determining the nature of the contract? Similar questions arise for instance with fibre optic cables. Does an entity have an exclusive right to use a fibre or does it have use of any fibre that happens to be free at a particular time. Or is the asset the cable as an indivisible whole? When looking at IFRIC 4 today, depending on the response you would have to these questions, you may have a different answer as to whether the contract qualifies as a lease or not.

In addition to these difficulties, the use of the specific asset criteria may lead to same strange results. For instance, if a shipping company provides a manufacturer with the right to use a ship to transport goods and only has one vessel in its fleet, this would be considered a lease (the asset is implicitly specified); however, if it has several vessels in its fleet and any one of these can be used for the purposes of transporting the goods, then there is no lease but a service contract. On the other hand, if only one vessel of the fleet is effectively available because the others are on the other side of the world, then the asset would implicitly be specific and again there would be a lease. However, in all three cases, the contracts and the service being provided are the same.

Another example of the difficulties arising around the notion of specific asset occurs in vehicle contract hire situations. Today, these contracts are commonly accepted as being (operating) leases. However, if the lessor does not have the obligation to make a specific car available to the lessee (for instance the car with a unique identifier in the form of a specific registration or chassis number), and is able to provide the lessee with a car of an equivalent category (e.g. make, model and certain options), these contracts may no longer be considered to be leases.

Consequently, we believe that IFRIC 4 guidance will require major clarifications to resolve the above issues if the new standard is to function effectively. Further, IFRIC 4 and SIC 27 requirements will clearly need to be written into the new standard and can no longer be distinct.

Leases with services

Many leases contain service elements in addition to the right to use the leased item. The DP acknowledges that these must be separated from payments for the right to use the leased asset. Leaseurope fully agrees that service payments should not be capitalised, as this would be inconsistent with standards for owned assets. However, the separation of such payments is unlikely to be a straightforward exercise in all cases. If detailed information is provided to lessees regarding the amount of services included in the lease, then lessees will obviously have no difficulty in separating these amounts from the right of use. Yet this will not always be the case.

Many lease contracts which contain significant service elements are very similar in nature to outsourcing contracts – the lessee effectively outsources all asset-related needs and costs to the lessor in exchange for a single, convenient invoice. Information on the different elements included in the payment is therefore often not provided by the lessor. Consequently, lessees will be required to estimate service payments in many cases. This could be done by comparing the lease to a lease with no services or to a stand-alone service contract. Whether it will be practicable or feasible for businesses to find equivalent contracts for comparison is questionable.

It is also important to keep in mind that these types of contracts, often classified as operating leases today, are becoming more and more popular as firms choose to focus on their core activities and tend to outsource those asset needs that are auxiliary to their business. In fact, the service package can often be the decisive factor in opting for a contract that takes on the form of a full service lease instead of another product or several, separate products. If these lessees are required in the future to estimate their service payments, to account for them separately from the right to use asset, to set up asset registers for right to use assets and incur major systems costs, part of the economic rationale for opting for these contracts falls away. We see this as being one of the many sources of complexity of the new proposals and consider that there is a very significant risk that the entire business model for these types of full service leases could be jeopardised, not to mention the consequences for more traditional forms of outsourcing contracts that include rights to use assets as explained above.

Classification requirements

By not re-considering scope issues or what a lease actually is, the Boards, and in particular the IASB, have not sufficiently debated whether there are different types of leases.

We note from our discussions with various stakeholder groups that for many it is unclear that so-called rental contracts are covered by the scope of the new standard (and the existing standard). This is because many jurisdictions make a legal or tax distinction between “leases” and “rentals” and the current IFRS accounting for “rentals” is operating lease treatment. Therefore, their accounting is very similar to that of a service contract.

In order to avoid any misunderstandings, it would be useful to explicitly point out that if there is to be no classification in a new standard, contracts referred to locally as rentals give rise to rights to use assets and therefore qualify as leases.

In this context, we note that all questions for constituents on the need to maintain some form of classification (whether it be today's classification or another kind of classification) included in the draft Discussion Paper published in October 2008 have been removed from the final version of the paper. Leaseurope is of the opinion that the Boards should have explicitly sought constituents' feedback on this issue.

Lastly, we feel that it is important to point out here that although the right of use model would apply equally to all leases (i.e. there will no longer be any difference between types of leases), in reality different accounting treatment is introduced according to whether or not title of the leased asset is expected to pass to the lessee (see our response to Q8 on subsequent measurement for our comments on the proposals relating to the amortisation period of the lessee's right to use asset). This seems to be inconsistent with a right of use model that would apply to all leases in the same way.

Q2. Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Given the significant level of complexity that the new proposals will introduce for all leases, and in particular for the small ticket end of the market which makes up a substantial share of the leasing business, Leaseurope takes the view that it is unreasonable to apply this approach across the board. Consequently, we would advocate a solution that does not impose disproportionate costs on the users of such types of contracts.

The costs of the new standard should not outweigh its benefits

Indeed, businesses that have to manage large numbers of small leases are those that will be the most affected by the complexity of a new standard. Yet as mentioned in our comments above, these leases are in fact very different to the large, sophisticated transactions that are the focus of standard setters' concern. The considerable additional burden for preparers to apply a new standard to constantly changing low value, high volume leases such as photocopier leases or company car leases is unlikely to bring about better information for users of accounts. Consequently, the issue of "scoping out" some leases (or another solution with equivalent effects) should be viewed entirely as a cost/benefit issue.

Achieving a proportionate standard

Basing an exemption on the notion of “short term” raises issues as to how to define what is short term. Although it would seem self-evident that daily rentals of vehicles for instance would not give rise to the creation of assets and liabilities, one would have to define the frontier between these contracts and other short term contracts that do. Some would say this limit should be for contracts for a term of less than 1 year. However, this would be arbitrary and would not alleviate the complexity concerns for, say, perk cars that are leased typically at terms of 2 to 4 years.

Some have argued that such leases would be covered by the notion of materiality that underpins all accounting standards. However, the existing concept of materiality may not be sufficient to avoid the difficulties mentioned above. Many of these small ticket items would still be higher than traditional company capitalisation policies and when deciding whether an item is material, preparers would already have to shoulder the burden of the calculation and will still be confronted with the complexities inherent in the new model for very simple, low-value pieces of equipment. Therefore, this does not solve the problem. Moreover, in our opinion it is unlikely that users will find financial reporting information more useful if balance sheets are cluttered with leases of these types of equipment.

Others have suggested that the materiality concept could be developed further in a leasing context. One way to expand this notion specifically for leases could to be draw a distinction between core and non-core assets by providing guidance aimed at, for example, trying to differentiate between an airline having to account for its aircraft under the approach presented in the Discussion Paper and having to treat its leased photocopiers or laptops in exactly the same way. Similarly, a haulage business should have to account for their truck leases under the approach, but perhaps not for its photocopier or printer leases in the same way.

Another way of defining a possible exemption would be to refer to leases of assets that are individually immaterial and fungible (i.e. they can be substituted for equivalent assets for instance in the case of cars, photocopiers, etc.) and that can be easily replaced on the open market. The exemption would have to be principles based and could be constructed in conjunction with the necessary clarification of IFRIC 4 as many of these contracts are also likely to contain significant service components.

The difficulty of this issue of course lies in defining clearly what is core and non-core. An alternative to the above possibilities could be to let preparers decide what leases of non-core assets are for them and to disclose this information in the notes to their accounts. For instance, a firm could decide that photocopier leases would not be capitalised but would describe this policy and the underlying reasons for this decision in the notes to their financial statements. We note that the concept of core and non-core assets, although difficult to define, is in fact referred to by the Boards in the DP (§6.49) as a business factor that could affect the lease term.

Moreover, we feel it is important in this context to stress that the Boards must not ignore the interests of SMEs. Although the proposed model may apply initially only to a relatively small number of public interest entities, it is highly likely that it will be applied subsequently to all reporting entities, whether directly by the IASB through IFRS for SMEs, or indirectly by national standard setters. It is also likely that it will also be applied eventually within the public sector. 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 because of the complexities of the approach. As described in Section 1 of this response, leasing is a key source of finance for these businesses and their use of the product should not in any way be undermined. The responsibility to take account of SMEs' interests sits firmly with the Boards, because the standard it is now considering will in due course have to be followed by small companies.

Whatever the Boards' future decision on the creation of a scope exemption for certain kinds of leases is, the Boards must carry out an in-depth cost/benefit analysis of the new approach. As explained earlier in our response, this type of analysis is severely lacking in the Discussion Paper and a clear case for the new model, weighing the benefits for users and costs for preparers must be made. At this point, Leaseurope has significant concerns that the new model will generate unjustified costs for preparers without necessarily providing better information for users. Once this analysis has been performed, the onus should be on the Boards to design any new standard in a proportionate manner.

CHAPTER 3 - APPROACH TO LESSEE ACCOUNTING

Q3. Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

In general Leaseurope agrees with the Boards' analysis of the rights and obligations and assets and liabilities that arise in the simple example considered. Nevertheless, we believe it is important that lessor accounting be consistent with this analysis.

Decisions taken for lessee accounting must be consistently reflected in lessor accounting

The Boards' justification for the lessee having a liability for its obligation to pay rentals is based on the notion that this obligation is non-conditional. This is because the lessor is deemed to have substantially completed its performance obligation upon delivery of the leased item to the lessee. Nevertheless, recent Board decisions for lessor accounting conclude the very opposite – that the lessor still has a performance obligation to permit the lessee to use the leased item and honour the contractual terms of the agreement even once it has delivered the item. Leaseurope fails to understand how these two conclusions can be reconciled and urges the Boards to reach consistency within the

lessee and lessor models. This is a fundamental conclusion on which the entire new proposals for lessee accounting lie. It is unacceptable for the Boards to reach completely diverging views on the same issue depending on whether it is examined from the point of view of the lessee or the lessor. If the Boards were to have considered lessor accounting issues in parallel with lessee issues, it is unlikely that they would have reached the decision they did for lessors. For instance, in the early stages of the project when it was thought that both sides of accounting would be dealt with together, the Boards considered the assets and liabilities arising under a simple lease for both parties. They concluded in March 2007 that “the lessor’s obligation to permit the lessee to use the leased item does not meet the definition of a liability”.

Leases may change in nature as they become more complex

Although the Boards consider more complex leases at a later stage, their fundamental decisions on the assets and liabilities arising in a lease and consequently their preferred model for lease accounting is based on a simple example which is very different to real life leases. Even run-of-the mill leases such as car or photocopier leases will include options to extend the contract or rentals that are based on a contingent factor such as usage of the asset. Additionally, we question whether leases may change in nature as they become what the Boards call more “complex”, i.e. as other features such as services, options, contingent rentals, etc. are added to agreements based on contracts taking on the form of a lease. If such “complex” leases are different in nature (e.g. they could be more like executory contracts than financing contracts), then it is not at all clear to us that conclusions which may be valid for the simple lease example remain true for these types of contracts.

Q4. The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

We wish to reiterate our earlier comments that we do not believe there has been sufficient analysis proving that an entirely new model for lease accounting is necessary. We therefore take the view that the Boards could opt for an approach which would retain the current model whilst improving disclosure requirements for users. In light of current circumstances, at the very least, further explanation should be given as to why this approach is not appropriate.

Nevertheless, if a case is made that a complete overhaul of the existing model is necessary, in the context of the simple lease example given in §3.6 of the DP, we broadly agree that the lessee should recognise an asset for its right to use the leased item and a liability for its obligation to pay rentals.

However, as explained in our response to question 3; many “complex” leases do not fit this model as they may be different in nature to “simple” leases. The fact that some leases can be executory should not be neglected. By forcing preparers to recognise assets and liabilities in such cases, the Boards would be departing from existing accounting literature for such contracts.

For leases other than simple leases or executory leases, we take the view that the most appropriate model would be a right of use model recognising committed lease payments (an adapted finance lease-type model). Please refer to our response to question 5 below for further details.

Q5. The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Leaseurope takes the view that the Boards’ decision to recognise a single asset and liability will lead to a flawed model for lessee accounting as the lessee will end up recognising assets and liabilities that it does not actually have. We therefore believe that this approach is inconsistent with the Conceptual Framework and will not provide users of accounts with improved information.

If components cannot be measured, they should not be recognised

We observe that the Discussion Paper states that a components approach would be the conceptually correct approach. We would tend to agree with this statement as individual components such as options, etc. may meet asset and liabilities definitions. However, 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.

Leaseurope

As a result, Leaseurope strongly disagrees with the inclusion of rights and obligations under optional periods in the leased asset and contingent rentals in the lease liability and we therefore oppose the Boards' proposal for a single asset and liability model. Further comments on these issues are provided below in our responses to the questions on the treatment of options, contingent rentals and residual value guarantees.

However, we would like to point out that the Boards, if they do decide to apply a new model, could envisage applying a model would involve the lessee capitalising only its committed lease payments. In comparison to the single asset and liability approach model set out in the DP, this would be much more straightforward to apply as it would avoid a significant amount of the complexity created when dealing with options and contingent rentals for instance. It would therefore be much less costly for preparers.

We note that a model maintaining the current treatment of components such as contingent rentals was an April 2008 recommendation of a group of Board members in charge of setting out concrete proposals for bringing about improvements to convergence projects before June 2011[7]. This recommendation appears to have been disregarded and is not referred to at all in the Discussion Paper.

If a clear case is made that a new model is necessary, Leaseurope would support a model which would involve capitalising only committed lease payments together with additional information on the nature of any additional components such as options, contingent rentals, etc. being provided in the notes to the financial statements.

CHAPTER 4 – INITIAL MEASUREMENT

Q6. Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Leaseurope broadly agrees with the Boards' tentative decision to initially measure the lessee's obligation to pay rentals at the present value of lease payments.

Discount rates

In theory, it would be preferable for the lessee to discount its lease payments using the rate inherent in the lease as this is the rate being charged. However, as stated in the DP this rate is indeed not always available to the lessee. When this rate is not provided by the lessor, the lessee may be able to calculate the rate in some circumstances. However, when the lessor has a larger residual interest in the leased asset, the rate inherent in the lease becomes more complex for the lessee to determine. As a result, it would seem

[7] Agenda Paper 3, April 21 IASB/FASB meeting

more appropriate for the lessee to the use its incremental borrowing rate in such cases as they will not have a real alternative in practice.

The Boards should note however that requiring the lessee to use the incremental borrowing rate under all circumstances may not necessarily be a simplification for preparers. Indeed, determining this rate may be an extremely costly exercise for lessees as they would need to estimate or obtain quotes from a number of sources for a rate that appropriately reflects the level of security provided by the leased item. The degree of security could also differ amongst various lease contracts and there is therefore no single incremental borrowing rate that can apply to all leases. Consequently, if lessees do have the rate inherent in the lease, it seems difficult to justify the additional burden of determining the incremental borrowing rate.

As a result, Leaseurope takes the view that it may be preferable to retain the current IAS 17 requirements for the discount rate to be used in the present value calculation.

Q7. Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?
If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Yes. Leaseurope takes the view that the value of the leased asset is equal to the value of the liability.

CHAPTER 5 – SUBSEQUENT MEASUREMENT

Q8. The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

As noted by the Boards, the asset and liability of a lease are intrinsically linked. Therefore, Leaseurope does not agree with the Boards' proposed approach but considers that subsequent measurement should reflect this specific, linked nature of leases. We propose a linked approach to subsequent measurement that differs from the one described in the Discussion Paper below.

Leases are specific instruments and should be measured as such

Leaseurope does not support the Boards' tentative decisions on the subsequent measurement of the lessee's asset and liability. While we do agree that this should be done on an amortised cost-basis, we note that auditors would almost always require the straight line depreciation of the right of use asset which results in the leased asset and liability being de-linked after initial measurement. Instead, we are in favour of applying a

so-called linked approach to subsequent measurement as the asset and liability inherent in a lease are intrinsically linked given that they originate from the same contract, contrary to a purchase of an asset financed by a loan where the loan and the purchase have two distinct contractual origins. As a result, we take the view that leases are specific instruments that merit specific measurement requirements.

The de-linked approach would lead to accounts that are not comparable

If the Boards' approach to subsequent measurement is adopted, this will lead to accounts that are neither comparable nor more understandable for users. Consider for instance two lessees of identical assets with the same market rentals, all else being equal. However, one lease is originally granted for 15 years and is 10 years into the contract while the second lease is for 5 years and is at inception. Although both lessees have identical rights and obligations, under the de-linked approach recommended in the Discussion Paper, the values of their assets in the accounts would be very different, as would the charges they record in the subsequent years. The first lessee would appear to be more profitable over the remaining period even though, commercially, its position is identical to that of the second lessee. Consequently, the accounts will provide a misleading comparison.

Equally, the de-linked approach to subsequent measurement will, in many jurisdictions, create book/tax timing differences that will not help improve the clarity of nor facilitate the comparability between lessee financial statements.

An alternative linked approach should be used for subsequent measurement

We consider that a linked approach to subsequent measurement should apply and would like to stress that such a linked approach does not necessarily have to be the one described in the Discussion Paper. Indeed, there is another kind of linked approach to subsequent measurement that would overcome all of the disadvantages identified in the paper that would enhance the understandability, relevance and reliability of financial reporting.

This alternative for subsequent measurement would be as follows. The 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 (see Example 1 below). 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.

Contrary to what is stated in the Discussion Paper, such an approach would not need to be applied to a particular category of leases but instead could be applied across the board to all leases, thus avoiding the necessity to differentiate between types of leases. 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.

This approach overcomes both the disadvantages with the linked approach described in the DP as well as the disadvantages related to the de-linked approach proposed by the Boards. Moreover, as shown in the example below, the de-linked approach will result in lessees showing an upfront increase in costs for no other reason than accounting treatment. Under the adapted linked approach mentioned above, lessees will recognise a straight line expense in the case of straightforward lease contracts with regular payments.

Example 1

The following example compares the accounts of a lessee of a simple equipment lease under:

1. Today's standard where the lease is assumed to be an operating lease
2. The new approach envisaged by the Boards where the right to use asset and the corresponding obligation are de-linked
3. The linked approach described in the DP
4. The alternative linked approach described above

The characteristics of the contract are as follows:

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

It is assumed that the lessee's incremental borrowing rate is 8% and that the lessee has a constant income stream of 2 000 EUR per year. For sake of simplicity and given the existence of diverging tax regimes and rates throughout Europe, taxation has been ignored in the example. Nevertheless, as pointed above, it should be noted that under an approach where the asset and liability are de-linked, burdensome tax/book differences will arise.

Example 1: Comparative financial statements under the various subsequent measurement approaches

	1. IAS 17 Operating Lease				2.Boards' tentative decision: De-linked approach			
	Initial	YR 1	YR 2	YR 3	Initial	YR 1	YR 2	YR 3
Balance sheet								
RoU asset	0	0	0	0	3,528	2,352	1,176	0
Lease liability	0	0	0	0	3,528	2,444	1,271	0
P&L								
Rent expense		1,326	1,326	1,326	-			
Depreciation	-	0	0	0	-	1,176	1,176	1,176
Interest expense	-	0	0	0	-	243	153	56
Total costs	-	1,326	1,326	1,326	-	1,419	1,329	1,232
P&L Earnings Format								
Income		2,000	2,000	2,000		2,000	2,000	2,000
EBITDA		674	674	674		2,000	2,000	2,000
EBIT		674	674	674		824	824	824
Earnings before tax		674	674	674		581	671	768

	3.Other approach discussed in DP: Linked approach				4.An alternative linked approach			
	Initial	YR 1	YR 2	YR 3	Initial	YR 1	YR 2	YR 3
Balance sheet								
RoU asset	3,528	2,444	1,271	0	3,528	2,444	1,271	0
Lease liability	3,528	2,444	1,271	0	3,528	2,444	1,271	0
P&L								
Rent expense		1,326	1,326	1,326				
Depreciation	-				-	1,083	1,173	1,271
Interest expense	-				-	243	153	56
Total costs	-	1,326	1,326	1,326	-	1,326	1,326	1,326
P&L Earnings Format								
Income		2,000	2,000	2,000		2,000	2,000	2,000
EBITDA		674	674	674		2,000	2,000	2,000
EBIT		674	674	674		917	827	729
Earnings before tax		674	674	674		674	674	674

Under the proposed approach, further clarification of the amortisation period is required

We also wish to point out that if the Boards decide to confirm their tentative decisions for subsequent measurement, the period over which the right to use asset must be amortised needs further consideration. The current wording in §5.40 of the DP states that this asset should be amortised over "the shorter of the lease term and the economic life of the asset" and that "for leases of items in which it is expected that the lessee will obtain title at the end of the lease term, the amortisation period would be the economic life of the leased item". It is extremely unclear as to what is meant by "it is expected that the lessee will obtain title" and the Boards appear to be introducing different measurement approaches for different types of leases. In order to be consistent with the rest of the proposal, the amortisation period should relate to the lease term.

Q9. Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

No. Leaseurope believes that as the asset and liability in a lease are linked, it is impossible to fair value the obligation to pay rentals on a standalone basis. Only the lease contract itself can be fair valued.

Q10. Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

Leaseurope strongly disagrees with any revision of the lessee's rate.

The Boards have decided that the lessee's liability is a financial liability. Therefore, requiring reassessment of the lessee's incremental borrowing rate would be inconsistent with the literature for these types of liabilities and a cost-based approach to subsequent measurement. Requiring such revisions would also impose immense burdens on preparers without providing improved information for users. Lastly, this would lead to the lessee's obligation varying according to changes in its credit quality and we do not believe that such changes should impact subsequent measurement.

Q11. In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

Leaseurope does not believe that the Boards should cross-reference to existing guidance. Leases are specific instruments that should be accounted for (and presented) as such.

Q12. Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.
Would you support this approach? If so, for which leases?
Please explain your reasons.

There may indeed be cases where it is inappropriate to describe the decrease in value of the right of use as amortisation or depreciation, particularly in situations where the lessee's objective is not to finance the purchase of an asset by means of a lease but when it is choosing to lease for other reasons, for instance when it wants to be able to benefit from asset solutions without "acquiring" the assets themselves. For example, when taking out a car lease, a firm may not be concerned about the vehicle itself, but instead wants the possibility that the contract offers in terms of providing solutions to visit clients or deliver goods. Equally, lessees are not interested in acquiring fork lift trucks but in managing the storage of their goods in a warehouse. These types of expense clearly relate to business operations and showing a rental expense in such cases may provide better information for users of accounts. This approach would also imply that the liabilities for these types of leases would have to be shown separately from other financial liabilities to avoid distorting leverage ratios.

CHAPTER 6 – LEASES WITH OPTIONS

Q13. The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

As stated above, Leaseurope does not agree with the single asset and liability approach. Consequently, we disagree with the proposed approach for dealing with options. While measuring the value of options included in a lease contact may prove to be difficult, requiring lessees to address uncertainty surrounding the lease term through recognition is not an appropriate alternative.

Dealing with uncertainty through recognition

Lessees are committed only for the initial lease term; they have no obligation to make payments beyond this original period. It is therefore questionable whether the Boards' favoured approach is consistent with asset and liability definitions. The all or nothing approach to recognition suggested by the boards will very often result in lessees showing assets and liabilities that are in fact far greater than their true rights or commitments.

Users need to understand what a company's rights and 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.

Moreover, this model completely fails to take into account the flexibility conveyed to lessees via the option. In the example given in the Discussion Paper, the lessee does not have a 10 year lease, nor does it have a 15 year lease; it has a 10 year lease with the possibility to acquire an additional 5 years usage if it so desires. This difference has to be reflected in the accounting treatment.

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. For example, a construction firm will chose to lease an excavator to use on a building site for an original term equal to the expected construction period. However, as significant delays can occur in construction, or a second construction contract may be signed later, the lease will allow the firm to prolong the use of the excavator for as long as required. Equally, the firm will be able to return the excavator if construction is competed ahead of schedule or to acquire the use of additional machines if needed. In this way, the company can tailor its operational asset needs to suit its business requirements. Purchasing these machines or taking out a lease for a fixed period would simply not be economically viable.

Under the example given, if the lessee were to recognise a 15 year lease, it would be effectively valuing its option at an amount equal to a full 5 years of rentals. While this option could be an asset of the lessee, its value can never be equal to such an amount and is therefore significantly overstated under this approach. In most cases, particularly in equipment leasing, there is very little volatility of the underlying right to use asset and/or of similar leases. Therefore the value of such options is low. Moreover, renewals and terminations are factored into the lease via the price of the rental payments. If the lessee capitalises payments that already take into account the option, it is further overstating the value of its asset.

Dealing with uncertainty through measurement

Given the above arguments, requiring the lessee to recognise the uncertainty surrounding the lease term via measurement would appear to be more correct as this would i) better reflect the flexibility of the option and ii) would not lead to the same level of overstatement of the option's value. However, the comment made in the DP that reliable measurement of probabilities of the option exercise is extremely difficult is a very valid point. In fact, if one were able to determine these probabilities, one may actually be able to calculate the value of the option on a standalone basis.

Neither approach provides an appropriate solution

Nevertheless, there are similar difficulties between 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 make an estimate of their most likely lease term is probably unfeasible or, at best, an extremely burdensome exercise involving a significant amount of guess-work.

Leaseurope therefore takes the view that the technically correct approach, conform with the Conceptual Framework, would be to measure such options separately. Yet, as stated above, if these options cannot be valued because there is no observable market for them or traditional option valuation models do not function, preparers should not be required to recognise them or should only do so when there is a clear indication that these are in fact valuable.

Determining the lease term

While Leaseurope is clearly not in favour of the suggested approach, we wish to make some comments on how lessees would determine the lease term in the event they were to be required to deal with options through recognition.

In addition to the concept of most likely lease term, the DP lists several alternatives to determining the lease term. The use of a probability threshold is dismissed on the grounds that is arbitrary and represents a rule. If the Boards decide to retain the recognition approach to options, Leaseurope would recommend that they reconsider these probability thresholds as they could lead to a more reasonable way of reflecting a lessee's commitments under options. Indeed, the most likely approach effectively determines an extremely low probability threshold above which the optional period must be reflected and will capture optional periods where there could be a "50/50" chance for renewal. Indeed, renewal may be the "most likely" outcome, not because the lessee has any compelling economic reason to renew (with the option value being extremely low and therefore representing an immaterial amount) but because it has not considered the

alternatives. These are often referred to as inertia renewals. Moreover, the “most likely term” approach can lead to some strange results. For instance, in the example given in §6.35 of the DP, the lessee effectively has a 55% chance to use the lease for a period of 15 years or longer. Determining a probability threshold that aims to capture optional periods where there is a real likelihood that the option would be exercised would therefore seem much more appropriate and there is no reason for such a threshold to be rules-based. In any event, such an approach does not seem to be more or less subject to abuse than the proposed approach as if a firm wishes to minimise its capitalised lease payments, it may very well still be able to do so under the most likely lease term approach.

Moreover, we find that list of suggested factors to be used in determining the lease term to be quite surprising as it explicitly excludes the lessee referring to past practice. Past practice is likely to be one of the significant indicators of whether or not a lessee will exercise options in the future.

Other comments on the approach to options

Additionally, comparability of financial statements between firms will be reduced as lessees with the same contracts may end up showing different amounts on their balance sheets according to their assessment of the most probable lease term even though they could have the same lease contracts and therefore the same assets and liabilities. Users will not be able to understand why this is the case nor are they likely to fully appreciate the underlying assumptions lessees will have used in determining these amounts.

Lastly, the DP focuses on renewal options. While we understand that options to terminate would be treated in the same way, we are of the opinion that the DP does not provide sufficient justification for this. Indeed, a case should be made clearly demonstrating that options to renew and to terminate are equivalent.

Conclusion

Given our comments above, our preferred approach to the treatment of options would be to not recognise them, unless they can be reliably measured and are judged to be material. However, lessees should disclose the nature of the options available to them in the notes to their financial statements.

At the very least, the Boards should explain why they believe that this model meets Framework definitions. This is particularly important as we note that this concept is being used in a number of other ongoing projects such as revenue recognition and insurance contracts. If the Boards are creating a precedent for future standards in such a wide range of domains, further consideration is an absolute necessity.

Q14. The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.
Would requiring reassessment of the lease term provide users of financial statements with more relevant information?
Please explain why.

If the Boards decide to go down their preferred route for dealing with options, Leaseurope would not be in favour of remeasurement.

Indeed, we do not believe that this approach would necessarily provide users of financial statements with improved information. On the contrary, a user's view is likely to be clouded by continuously changing lease assets and liabilities and the comparability of successive balance sheets will be impaired. Moreover, users will not be able to identify fixed commitments. Useful information on a business's value and risks lies only within the fixed commitment made by the company yet under this approach, financial statements will be increasingly volatile and procyclical as lessees are likely to be optimistic about their renewal intentions in good times and more prudent during phases of weaker economic conditions.

This approach will also clearly be extremely costly for preparers to apply. In our opinion, these costs would significantly outweigh benefits for users (if any).

Q15. The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.
Do you agree with the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Leaseurope does not agree with the proposed approach.

Similarly to the proposed treatment for renewal options, requiring lessees to include the present value of the exercise price of purchase options in their obligation to pay liabilities will in many cases dramatically overstate the value of the option. Consider for instance a lease that grants the lessee an option to purchase the leased item at the end of the lease term for an amount equal to the fair market value of the asset. Such an option has little, if any value at all as the lessee could simply go out and purchase the asset for the same price in the market. Yet lessees will have to include the full present value of this exercise price in their lease payments. In addition to assessing the likely exercise of this option which cannot amount to more than guess work, the lessee will also have to estimate the future market value of the asset.

We therefore do not agree with the proposal and consider that purchase options, as other options, should only be taken into account if they can be measured reliably and are judged to be material.

CHAPTER 7 - CONTINGENT RENTALS AND RESIDUAL VALUE GUARANTEES

Q16. The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.
Do you support the proposed approach?
If you disagree with the proposed approach, what alternative approach would you recommend and why?

Leaseurope does not agree with the proposal as we consider the single asset and liability approach to be inappropriate for dealing with rentals that are based on a contingent factor. We would recommend instead that contingent rentals be dealt with in the same way as they are in the current model. Nevertheless, in order to provide constructive input to this debate, we have outlined an alternative approach below.

Dealing with contingent rentals through a single liability approach

The proposed approach for dealing with contingent rentals implies that the lessee may be recognising obligations that it has the discretion to avoid in certain circumstances, thus 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 to their nature. Treating all contingent rentals in the same way will not provide better information for users of financial statements.

Consequently, if the Boards do not decide to maintain the current approach to dealing with contingent rentals, Leaseurope would recommend distinguishing between those contingent rentals that do give rise to a liability (i.e. present, unavoidable obligations) that can be reliably measured and those that are not liabilities (or those that are liabilities but cannot be reliably measured).

Performance and usage based rentals

We observe that rentals which are entirely contingent and based on a performance factor such as turnover are extremely rare in equipment leasing contracts but more common in real estate leasing. For example, this type of feature can be found in commercial property developments. In order to ensure the presence of an anchor tenant (such as a well known supermarket or fashion chain) in the development, the lessor will base the rentals of the anchor tenant on a percentage of its future sales. It is unlikely that the lessee will effectively be able to avoid payments as there is clearly an underlying economic rationale for its choice to establish a commercial premises. Generally, such

contracts are likely to include clauses that oblige the lessee to operate. Consequently, in such cases, Leaseurope suggests that the lessee does recognise a liability for these payments and that uncertainty relating to the actual amount to be paid be reflected though measurement.

However, it is not because these types of contingent rental situations exist that all such rentals should be dealt in the same way. Indeed, there may be certain circumstances where the lessee is able to avoid paying rentals by choosing not to operate or use the asset. If there is no element that obliges the lessee to do so, the lessor is effectively taking a risk that it will not receive any payments. Therefore, in such situations, Leaseurope sees no justification for arguing that the lessee has a liability that should be recognised; the lessor would certainly not have a corresponding asset. Similarly, in cases where contingent rentals are based on usage of the leased item, lessees may not always have a fixed commitment to effectively make use of the asset.

Consequently, lessees should only recognise liabilities for their contingent rentals when they effectively do have a present obligation. This will depend on the terms of the lease and the lessee's particular situation.

Contingent rentals for additional usage

In cases where rents are based on additional mileage for a car lease or extra copies for a photocopier lease for instance, these rentals will contain a significant service component. Given that service payments should not be capitalised, these payments should be separated from the payments for the right to use the asset. It is highly unlikely that lessees will be able to estimate the portion of the contingent payment for additional use that is linked to the provision of services.

Leaseurope takes the view that such contingent rentals are of a purely executory nature as, at the start of the contract, neither party has performed until additional usage is made of the asset. These types of contingent rentals should therefore be expensed when occurred and should not be included in the lessee's liability. If these rentals are treated in the way suggested by the Boards, not only will lessees end up capitalising service payments on their balance sheets, which is inconsistent with existing accounting literature and will not provide users with better information, the accounting model will again fail to reflect the true flexibility that lessees have acquired by choosing to lease in this format.

Rentals based on changes in an index or rate

Leaseurope also recommends that contingent rentals based on changes in an index or rate be accounted for as suggested by the FASB. The reasons for this can be found below in our response to Question 18.

Q17. The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.
Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Leaseurope considers that for those contingent rentals that are effectively liabilities, lessees should adopt the most likely rental payment approach.

Measurement of contingent rentals is likely to be extremely burdensome

Leaseurope is of the opinion that the two approaches may not be that different in practice as it is likely that under the most likely rental payment, lessees will also have to analyse different scenarios and associate probabilities to these scenarios, even if these are not formally assigned (we understand the level of formal calculation required to be the difference between the two approaches).

Nevertheless, the difficulty of performing such exercises should not be underestimated and we see this approach as being an entirely theoretical solution. Companies simply do not have reliable data on most contingent rental payment scenarios (the same is true for their likelihood of option exercise as pointed out above). This is a very different situation to provisions such as loan loss provisions (where preparers have models in place to produce estimates) or to provisions for law suits for example where preparers will seek the guidance of external advisers to assess likely outcomes.

On balance, we would prefer the "most likely rental payment" approach as the calculation burden may be less important, although as explained above this is not entirely clear in our opinion. The notion of most likely rental payment also appears to be more consistent with the most likely lease term approach discussed in chapter 6 of the DP. Although this is not our preferred approach for options, at a minimum, internal consistency within the new standard should be ensured.

Q18. The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

Leaseurope considers that rentals based on a change in an index or rate should be included in the lessee's liability as the lessee has no discretion to avoid such payments.

We consequently support the FASB's suggested approach for these types of contingent rentals i.e. with initial measurement being performed using the index or rate existing at inception of the lease, with changes in amounts payable arising from variations in the underlying rate or index being recognised in profit or loss. This would be consistent with the treatment of other financial liabilities based on a variable rate, while the IASB approach would not.

Q19. The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

Again, we believe that requiring remeasurement of the lessee's obligation at each reporting date to be an extremely burdensome exercise that will not necessarily always result in clearer information.

We consider that it would be more appropriate to require remeasurement only when necessary, in other words, lessees should not be required to remeasure their liability in the absence of any clear indication that there have been changes.

Q20. The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

If lessees are to recognise liabilities for their contingent rentals and remeasurement is necessary, Leaseurope would basically support that any changes be recognised through an adjustment to the carrying value of the asset as these changes are likely to correspond to a change in the right of use asset. However, as stated above, changes to contingent rentals based on indexes or rates should be recognised through profit or loss.

Q21. The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.
Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Leaseurope does not believe that an approach combining the lessee's liabilities to include residual value guarantees would provide users with a clearer picture of the lessee's commitments. In particular, residual value guarantees are of a very different nature as they relate to the value of the leased item.

We also note that the DP proposes to capture options and contingent rentals in a way that will lead to the lessee having in many cases a larger liability than it would in comparison to the current standard (under an operating lease). On the contrary, the decision to recognise only a probability weighted or most likely estimate of the amount payable under a residual value guarantee will often lead to the lessee recognising less on its balance sheet than it would under the current standard, where the maximum amount payable under a lessee-provided guarantee is taken into account.

Lastly, we would also like to point out that not much time has been spent discussing the nature of residual value guarantees and that given that it is the last of a series of important items concerning lessee accounting, constituents are also unlikely to provide substantial input to the Boards on this point. Particularly from a lessor point of view, residual value guarantees are significant features of lease contracts and we are of the opinion that they should be extensively deliberated going forward. The Board may be required to review any previous conclusions on guarantees granted by lessees in light of future discussions.

If the Boards were to adopt the DP approach, our comments regarding remeasurement for contingent rentals hold for residual values too, that is to say remeasurment should only be performed if there is a reason to do so and any changes should be reflected though an adjustment of the carrying amount of the asset.

CHAPTER 8 - PRESENTATION

Q22. Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

Leases are distinct instruments with specific characteristics. As a result, Leaseurope takes the view that they should be shown on a separate line of the balance sheet, on both the asset and liability side.

Given that the DP approach involves a single liability for the lessee incorporating financial liabilities and non-financial liabilities into one item, these must be shown separately from straightforward financial liabilities. Users will not be able to understand lessee obligations if these are not reflected separately. Moreover, the numerous reassessments that lessee may be required to make under the new proposals will be even more difficult to comprehend if there is no separate presentation.

Q23. This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.
How should the right-of-use asset be presented in the statement of financial position?
Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

For the reasons given above, we think that leased assets should be shown as a distinct asset class.

However, if the Boards decide that right of use assets are not distinct assets, Leaseurope would favour presentation based on the nature of the underlying asset as this shows the type of asset that is being made available for use and is likely to provide better information for users. However, it is extremely important the leased assets are identified separately from owned assets. If there is no distinction, in case of lessee bankruptcy for instance, creditors will not be able to identify which assets belong to the company and those that are under lease and belong to others.

We believe however that more debate is required as to nature of the lessee's right to use asset. One may reach different conclusions (i.e. intangible asset classification vs classification based on the nature of the underlying leased item) depending on how one views the right to use notion. If the right to use notion encompasses the idea that ownership of a physical asset conveys a series of rights to the owner of those rights, then it seems that presentation based on the underlying asset would make more sense.

Nevertheless, if it is deemed that the lessee is simply acquiring a right, in this case to make use of an asset which is different to full ownership rights, then perhaps presentation along with other types of rights as intangible assets would be more appropriate. We would however caution the Boards that presenting rights of use as intangible assets would have major ramifications, including significant impacts on the capital requirements of lessees operating in the banking industry.

CHAPTER 9 – OTHER LESSEE ISSUES

Are there any other lessee issues not described in this discussion paper that should be addressed in this project? Please describe these issues.

We have indicated throughout our response areas where we consider more work needs to be done on lessee accounting in addition to the items identified in chapter 9 of the DP.

We note that two of the issues identified in chapter 9, i.e. sale and leaseback transactions and initial direct costs, were discussed by the IASB during their 18 June 2009 Board meeting, along with impairment, revaluation and transition issues. As tentative decisions were taken during this meeting, we believe that it is not appropriate to comment on the sections of the DP dealing with sale and leasebacks and initial direct costs given that they no longer reflect the most recent state of discussions. Therefore, we will revert to the Boards at a later stage (but as soon as possible) with our views on all of these important issues, including those not mentioned in the DP.

CHAPTER 10 – LESSOR ACCOUNTING

As mentioned in our comments in Section 2 above, since the publication of the Discussion Paper, the Boards have taken tentative decisions on lessor accounting.

Consequently, we will not respond to the questions of this chapter *per se* but will address these issues and describe our preferred approach for a lessor accounting model in the subsequent section of our comment letter.

Section 4. LESSOR ACCOUNTING

As pointed out in our comments in Section 2, at this point in time, it is highly uncertain as to how the Boards will proceed with respect to lessor accounting. Nevertheless, in May 2009, the IASB and FASB took tentative decisions on a future lessor accounting model. Moreover, at an industry event on lease accounting organised on the 22 of May 2009, IASB member Warren McGregor indicated that there would be no Discussion Paper on lessor accounting and that constituents would in practice have the next few months to informally contribute to the development of lessor accounting.

There is therefore a clear risk that a lessor accounting model is included in an exposure draft phase without any official prior public consultation.

We particularly struggle with the way lessor accounting is being dealt with as Leaseurope has offered in the past to work with the Boards and their Staff to develop background work on a lessor model. At that time, industry representatives were told that lessor accounting would not be dealt with for a number of years and that it would therefore be more useful to concentrate on lessee accounting. As a result, all efforts have been focused on lessee accounting and the leasing industry is not in a position to provide substantial input on the lessor side, particularly in such a short time frame. Moreover, one can easily imagine that it will be even more difficult for other constituents to provide any input whatsoever at this stage. It is also apparent that most constituents are not even aware of these recent developments.

In our view, given the extremely poor communication on lessor accounting issues and the failure to consult stakeholders on lessor accounting 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. A quick-fix solution for lessor accounting without proper consultation is not an option.

This being said, in an effort to provide constructive input to a lessor accounting model, we have attempted to address the issues raised by the tentative decision of May 2009 and have suggested an alternative approach in our comments below.

Recent approach to lessor accounting

In May 2009, the IASB tentatively decided to "develop an approach whereby the lessor retains the leased item in its statement of financial position and

- recognises an asset for its right to receive rental payments from the lessee and
- a liability for its performance obligations under the lease." [8]

As the Boards have decided that the lessor has a performance obligation to deliver the leased asset and allow its use over the lease term, this implies that revenue will also be recognised over the lease term. This would seem from our understanding of Board discussions to have been one of the motivators for this choice.

Conceptual inconsistencies inherent in the recent approach

Leaseurope believes that the flaws in the above model result from the fact that the Boards have not considered lessee and lessor accounting in parallel. This does not necessarily mean that lessor accounting has to be a mirror image of lessee accounting in all circumstances. However, decisions do need to be consistent to avoid arriving at the wrong conclusions.

The entire right of use model developed for lessees rests on the Boards' 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 Boards 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 Boards 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.

The Boards must consider the multiplication of assets that their lessor approach generates. It is conceptually difficult to justify that if a wholly owned asset has a value of 100, then the fact of separating some of the rights attached to ownership and making them available to a third party can lead to the asset virtually doubling in value (i.e. the physical asset the plus right of use); there is still only one asset generating one stream of economic benefits.

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[8] IASB Update, May 2009

The effects of such an approach

Over and above these conceptual inconsistencies, the above approach to lessor accounting would have the following, 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 day-one revenue on these transactions. This would effectively imply that the direct leases of such captive companies as well as the many leases entered into through vendor programmes will no longer be viable means of sales finance, resulting in a reduced offer of financial products for end-user customers.

The acid test for a full lease accounting model is to consider the accounting of a sub-lease operation. Such operations are commonplace in the leasing industry and if satisfactory accounting cannot be achieved for such deals, then this is a strong indicator that the lessor and lessee accounting models are mutually contradictory and that one or the other, or both, need to be modified.

Example 2

We have therefore applied the Boards' suggested approach for lessor accounting to a sublease situation in example 2. The assumptions made in example 1 earlier in our response to questions on subsequent measurement hold and:

- The terms of the sublease are the same as those of the head lease
- The lease contract is for 36 months and the leased equipment has an economic life of 48 months.
- The lessee's incremental borrowing rate is assumed to be equal to the lessor's rate of return in all cases (8%)

Under the Boards' proposed approach:

1. The head lessor shows the leased asset in its balance sheet and depreciates it over its economic life. It recognises a receivable for its right to receive rentals and a payment obligation, relieved evenly to income over the lease term.
2. For the incoming lease, the intermediate lessee/lessor recognises an asset for its right to use, depreciated on a straight-line basis over the lease term, and a liability for its obligation to make payments to the head lessor. For the outgoing lease, it does not derecognise its right to use asset but recognises a receivable for its rights to receive rentals and a payment obligation, relieved evenly to income over the lease term.
3. The sub-lessee recognises the right to use asset and a liability for its obligation to make payments to the intermediate lessee/lessor.

Example 2: The Boards' approach to lessor accounting applied to a sub-lease situation

1. Head lessor

	Initial	YR 1	YR 2	YR 3
Balance sheet				
Leased asset	4,000	3,000	2,000	1,000
Receivable	3,528	2,444	1,271	0
Performance obligation	3,528	2,352	1,176	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Depreciation fixed asset		1,000	1,000	1,000
Interest on receivable		243	153	56
Performance of lease obligation		1,176	1,176	1,176
Net result		419	329	232

2. Intermediate lessee/lessor

	Initial	YR 1	YR 2	YR 3
Balance sheet				
RoU Asset	3,528	2,352	1,176	0
Receivable	3,528	2,444	1,271	0
Obligation to pay rents	3,528	2,444	1,271	0
Performance obligation	3,528	2,352	1,176	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Deprecitation RoU		1176	1176	1176
Interest on receivable		243	153	56
Interest on rental obilgation		243	153	56
Performance of lease obligation		1176	1176	1176
Net result		0	0	0

3. Sub-lessee

	Initial	YR 1	YR 2	YR 3
Balance sheet				
RoU Asset	3,528	2,352	1,176	0
Obligation to pay rents	3,528	2,444	1,271	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Depreciation RoU		1176	1176	1176
Interest on rental obligation		243	153	56
Total costs		1419	1329	1232

As can be seen from example 2, if the leased asset is not de-recognised, the shortcomings of such a model become obvious as there are effectively five assets in the system representing the leased asset (or rights to use this asset). Yet, in reality, only one party effectively has the right to use the item.

There are also other, very significant issues with this approach. Many European leasing firms belong to banking groups[9]. As a result, European banks have to hold a minimum amount of capital for their lease exposures in accordance with the Capital Requirements Directive. Today, these requirements oblige banks to set capital aside for exposures which are defined as minimum lease payments (regardless of whether the lease is a finance or an operating lease). However, 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. 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 source of funds which is on average responsible for financing around 20% of all investment.

For this reason alone, the Boards should reconsider their previous decisions.

An alternative approach is necessary

Leaseurope therefore recommends that the Boards consider an approach to lessor accounting which would involve the lessor derecognising the leased asset and recognising an asset for its residual rights in the leased item at the end of the leased term. As becomes clear in example 3 below, where we have applied this approach to the same sublease situation as in example 2, this is the only approach that would avoid the creation of multiple assets. In this case, only the sub-lessee shows the right to use asset on its balance sheet and indeed, the sub-lessee is the only party who has these rights to the asset. We would also like to point out that we believe this approach to be consistent with the Basis for Conclusions in the Derecognition Exposure Draft which states that "two parties cannot control the same asset simultaneously"[10].

Example 3.

This example shows the alternative approach to lessor accounting applied to the same sub-lease situation as in example 2 above. The assumptions made are therefore the same.

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[9] According to Leaseurope's 2007 Ranking Survey of European leasing firms, 18 of the top 20 leasing companies in Europe are bank related

[10] BC18, Exposure Draft ED/2009/3, Derecognition, Proposed Amendments to IAS 39 and IFRS 7

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Under this alternative approach:

1. The head lessor derecognises the leased item but recognises its residual interest in the leased asset. This is measured at present value at the start of the lease (discount rate 8%). Interest is accrued to the asset's expected value at the end of the leased term using the effective interest method. It recognises a receivable for its right to receive rental payments.
2. In the incoming lease, the intermediate lessee/lessor has a right to use asset and an obligation to make rental payments to the head lessor. In the outgoing lease, the right to use asset is de-recognised and the intermediate lessee/lessor recognises a receivable for its right to receive payments from the sub-lessee. It receives interest on its receivable from the sub-lessee and pays interest on its obligation to the head lessor.
3. The sub-lessee recognises the right to use asset and liability for its obligation to make payments to the intermediate lessee/lessor. Its right of use asset is depreciated using mortgage amortisation.

Example 3: The alternative approach to lessor accounting applied to a sub-lease situation

1. Head lessor

	Initial	YR 1	YR 2	YR 3
Balance sheet				
Receivable for residual value	476	514	556	600
Receivable	3,528	2,444	1,271	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Interest on RV receivable		38	42	44
Interest on receivable		243	153	56
Net result		281	195	100

2. Intermediate lessee/lessor

	Initial	YR 1	YR 2	YR 3
Balance sheet				
Receivable	3,528	2,444	1,271	0
Obligation to pay rents	3,528	2,444	1,271	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Interest on receivable		243	153	56
Interest on rental obilgation		243	153	56
Net result		0	0	0

3. Sub-lessee

	Initial	YR 1	YR 2	YR 3
Balance sheet				
RoU Asset	3,528	2,444	1,271	0
Obligation to pay rents	3,528	2,444	1,271	0
	Initial	**YR 1**	**YR 2**	**YR 3**
P&L				
Depreciation RoU		1083	1173	1271
Interest on rental obligation		243	153	56
Total costs		1326	1326	1326

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Conclusion

In conclusion, Leaseurope takes the view that the alternative model described above is the only conceptually sound and practically acceptable solution for a right to use model that would apply to lessor accounting.

However, many other issues will need to be dealt with in the context of a lessor model and while we understand that the Boards' Staff is working on these issues, at this stage we are not in a position to provide further input on lessor accounting as we are not aware of the current direction of their thinking. We will therefore provide further feedback at a later stage and remain entirely committed to assisting the Boards in their work in this field.