The Voice of Leasing and Automotive Rental in Europe

To : Françoise Flores, Chair, EFRAG Technical Expert Group

Leaseurope's Comments on Future Impairment Requirements for Lessors

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Dear Françoise,

This letter sets out Leaseurope's comments on the impairment requirements for lessors under the new Leases Exposure Draft (ED) and the Financial Instruments: Expected Credit Loss Exposure Draft

Our comments aim to link the requirements defined in the Leases and Expected Loss proposals as they relate to lessors. In this context, we hope that they can serve as an input to the work of both project teams.

Based on our current understanding/interpretation of the Leases proposals, we are concerned that lessors would be forced to recognise impairment/credit losses even in cases where the investment in the lease would still be recoverable. Beyond credit losses, we also have concerns with applying IAS 36 impairment requirements to residual assets under the new Leases ED.

Please do not hesitate to contact us for any questions you may have this comment letter.

Yours sincerely,

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Leaseurope

Lessor Impairment under the new Leases ED

1. How impairment for lessors works under IAS17 today

Finance leases

According to IAS17, a lessor recognises assets under a finance lease and presents them as a **receivable** at an amount equal to the **net investment in the lease**. The net investment in the lease is the aggregate of minimum lease payments **and any unguaranteed residual value** discounted at the rate implicit in the lease.

Lease receivables (i.e. including the residual value) held by a lessor are subject to the impairment provisions of IAS39

Operating leases

Lessors present assets subject to operating leases according to the nature of the asset. The depreciation policy for depreciable leased assets shall be calculated in accordance with IAS16 or 38.

IAS 36 is applied in accounting for the impairment in these assets.

2. What the new Leases ED says

Lessor recognition

The Leases ED requires lessors to recognise the **lease receivable** at the present value of the lease payments, discounted using the rate the lessor charges the lessee.

The definition of **lease receivable** under the Leases ED is **different** to IAS17 as it does not include the residual. The measurement of the residual is provided in §71 of the ED. When the fair value of the leased asset is the same as the cost of the asset, the residual is the PV of the expected value of the asset at the end of the lease.

Lessor impairment requirements

The Leases ED sets out the following impairment guidance for lessors:

§84. "A lessor shall determine whether the **lease receivable** is impaired and shall recognise any impairment in accordance with IAS 39 Financial Instruments: Recognition and Measurement. When determining the loss allowance for a lease receivable, a lessor shall take into consideration the collateral relating to the receivable. The collateral relating to the receivable represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term."

§85. "A lessor shall apply IAS 36 to determine whether the **residual asset** is impaired, taking into consideration any residual value guarantees relating to the underlying asset when assessing impairment of the residual asset. A lessor shall recognise any impairment loss in profit or loss in accordance with IAS 36."

3. The issue for lessors applying the new Lease proposals with regards to impairment for credit losses

At first glance, it seems "logical" that the lease receivable should be tested for impairment in accordance with IAS39 (or the future impairment standard). However, because the definition of a lease receivable in the Leases ED is different to that of IAS17, the impairment rules will apply to a different unit of account than they do today. In other words, today a lessor tests its net investment in the lease for impairment. If under the future Leases standard it is not allowed to the same, this will result in a lessor being forced to recognise impairment losses that it actually does not have in cases where the value of the leased asset covers any credit loss.

In practice, where there is any indication of impairment/expected loss, lessors look to the underlying asset. Indeed, lessors will take possession of the leased asset immediately on default of the lessee and seek to realise the asset in cash as soon as possible - in this way the lessor will recover its "investment in the lease" wholly or partly, and in some cases, can achieve proceeds on asset disposal over and above the carrying value of the net investment in the lease.

This practice does not have any regard to the distinction between how much of the investment in the lease relates to outstanding receivables and how much relates to the interest in the residual asset. Any allocation between the two parts is entirely arbitrary and belies the economic reality and business model of the lessor. Hence any attempt to "force" an allocation of the value of the leased asset to each component could undermine the credibility of the business as it would suggest a management of each component in a way which would not be an efficient and effective use of the entity's resources - indeed the accounting could distract management's focus from the key activities of managing the exposure.

4. Changes in the future standards (Leases/Impairment) for impairment due to credit losses

In light of the above, we consider that the the unit of account for a lessor's impairment activity should be its *investment in the lease*.

We note that the IASB and FASB themselves have recognised that the lessor is seeking to achieve a return on its *entire investment in the lease* (i.e. the receivable and residual, referred to as "lease assets" in the new Leases ED) – hence their decision to accrete the residual asset over the lease term and to require presentation of these lease assets as a total.

Considering impairment at the level of the lease assets reflects economic reality and business practice and avoids any arbitrary allocation of the fair value of the underlying asset to the lease receivable and residual asset. It is also the level at which users of accounts expect the lease exposure to be managed. Impairment would need to be measured by reference to the cash flows that are expected to arise, including proceeds on asset disposal. Hence it would seem reasonable to continue to use an approach similar to that today.

This would require that the following changes be made to the future leases and impairment standards:

Change to the future leases standard

§ 84 and 85 of the Leases ED must be changed so that it is clear that impairment is assessed by comparing the fair value of the underlying asset to the carrying value of the lease assets (or net investment in the lease).

Change to impairment standard(s)

If the Leases ED becomes a future standard, the scope of either the existing impairment rules in IAS39 or the new impairment standard will need to be revised so as to refer to lease assets (or net investment in the lease) instead of the current terminology of lease receivable as used in IAS 39 §2 (b) (i) or in the corresponding scope requirements of the Financial Instruments: Expected Credit Loss ED.

The specific changes that will need to be made to impairment guidance will depend on whether/when the new impairment standard is finalised.

5. Impairment for changes in underlying asset values

Sections 3 and 4 above considered *credit loss* impairment issues for lessors. Here we look at impairments related to asset risk.

As already explained, those lessors who currently have operating leases apply IAS36 to their leased assets. The Boards have “transferred” this requirement into the new Leases ED by requiring lessors to assess the residual asset for impairment in accordance with IAS36. However, while this requirement works well when assessing “current” physical assets, this simple transposition does not work in the context of residual assets, which represent “future” physical assets (that the lessor will obtain at the end of the lease when the full sets of its rights are reunited).

Of course, lessors must consider whether the expected value of the leased assets at the end of the lease may change. For instance, there may be an event that provokes a downward movement in second hand asset prices which would mean that the originally projected value of residual asset at the end of the lease would be overstated, albeit the investment in the lease could still be recoverable. Equally, second hand asset values could also move upwards.

We suggest that in the context of the new Leases ED, it is more appropriate for lessors to reflect these movements in prices by adjusting their accretion of the residual asset to their latest forecast value of the residual (i.e. to the expected value of the asset at the end of the lease) rather than apply the ED approach. Particularly if done on a portfolio basis, this would consistent with lessor business models and is the equivalent of applying the required depreciation and impairment rules of IAS16 and IAS 36 (that are used in an operating lease context) to a right of use model. Moreover, accounting for movements in the lessor's estimates of future asset prices provides much more meaningful information to users of accounts who want to understand the effects of these movements would have on a lessor (i.e. the extent of their exposure to asset risk).