

Brussels, 25 January 2010

**To: Sir David Tweedie, Chairman IASB
Robert Herz, Chairman, FASB**

Comment Letter on Accounting for Lessors

Dear Sir David, dear Mr Herz,

Leaseurope welcomes the IASB and FASB's recent decision "to develop accounting requirements for leases by considering the accounting from the perspective of both the lessor and lessee"¹, but wishes to comment on the Boards' emerging thinking on these new requirements.

In July 2008, the Boards decided to focus exclusively on lessee accounting issues and to defer the consideration of accounting for lessors. At that time, the European leasing industry pointed out that lessee accounting could not be dealt with on a stand-alone basis as the analysis of the rights and obligations inherent in a lease contract cannot be considered in isolation from the point of view of only one party to the transaction. Furthermore, introducing a new model for lessee accounting without reviewing lessor accounting would have implied that the many businesses that are simultaneously lessees and lessors would have had to apply different models for the same transactions for an unknown period of time. Nevertheless, the Boards continued to concentrate on lessee accounting and the March 2009 Leases Discussion Paper contained only a very short chapter on lessor accounting without presenting any preliminary views on these issues. However, almost all of the comment letters that referred to lessor accounting clearly stated that the Boards should deal with lessee and lessor accounting together. The Boards' November 2009 statement that they intend to effectively consider the accounting from both sides is therefore a very positive development in this project that is welcomed by the industry.

This being said, the European leasing industry maintains that it is still necessary for the Boards to issue a new Discussion Paper that comprehensively addresses both lessee and lessor accounting together. This would allow commentators to consider implications from both perspectives for the first time and test consistency. Moreover, given that leasing is in many jurisdictions a regulated activity, there is a very real need to consult regulators on this issue, thus further reinforcing the need for a new Discussion Paper. Proceeding directly to an Exposure Draft phase for lessor accounting without gathering constituents' views on the Boards' initial thinking on lessor accounting, and whether this fits in coherently with a model for lessees, may be counterproductive and ultimately jeopardise any final standard's credibility and acceptance.

¹ Joint statement of the FASB and IASB, *FASB and IASB Reconfirm Commitment to Memorandum of Understanding*, 5 November 2009

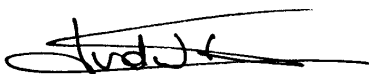
We are concerned that the Boards are now simply rushing through lessor accounting issues in an effort to include them in an Exposure Draft. We strongly believe that, had they duly considered lessee and lessor accounting together from the start, the conclusions reached in the March 2009 Discussion Paper for lessee accounting may very well have been different. A new Discussion Paper therefore seems necessary and, while we understand that this could ultimately lead to the Boards not meeting their June 2011 deadline for a final leases standard, many comment letters indicate that constituents would be willing to accept this as a necessary delay for a truly improved standard.

Leaseurope is of the opinion that the lessor model the Boards have recently voted in favour of (the performance obligation model) is severely flawed and does not depict the economic realities of leases and the leasing business. Again, we think this situation has arisen because the Boards are now forced to find a quick-fix for lessor accounting, something we cautioned against at several occasions². Whether or not the Boards choose to issue a second, comprehensive Discussion Paper, Leaseurope would encourage them to engage with the leasing industry and take its concerns into account in their deliberations to much greater extent than they have done so far³.

In an effort to participate constructively in the standard setting process for leases, this unsolicited comment letter therefore sets out Leaseurope's views on a future accounting model for lessors. We hope that the Boards will duly take these views into account and make them available to other stakeholders through publication of this letter.

We remain at your disposal to discuss these issues at your convenience and would be delighted to work with staff in developing the approach further. 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 this paper.

Yours sincerely,



Tanguy van de Werve
LEASEUROPE DIRECTOR GENERAL



Mark Venus
CHAIR, LEASEUROPE ACCOUNTING COMMITTEE

² See for instance our letter of 11 June 2008 to the Chairman of the IASB or our letter of 24 March 2009 to the IASC Foundation Chairman and Due Process Oversight Trustee Committee Chairman

³ The response to Leaseurope of the Due Process Oversight Trustee Committee Chairman dated 10 August 2009 states that "The Chairman of the IASB has assured the Trustees that further work on the leasing standard will be carried out in conjunction with the leases working group and with appropriate public consultation with all stakeholders. When the IASB addresses lessor accounting they will find ways to engage intensively with industry and investors, to ensure their voices are heard."

Leaseurope's Views on Accounting for Lessors

I. High Level Principles for Lessor Accounting

Before detailing our views on lessor accounting, we believe that it is important to stress that any model for lessors should respect the following, fundamental principles:

Accounting for lessors should:

- Provide a true and fair view of a lessor's financial position.
- Faithfully represent the economic reality of individual lease transactions in a way that is consistent with lessors' business models and reflects their exposure to risk
- Be simple for users to understand and for preparers to apply. In this context, a cost/benefit analysis must be carried out and prove conducive.
- Be conceptually consistent with accounting for lessees, other IASB projects and, more generally, with the Conceptual Framework.
- Not undermine the credibility or viability of leasing, particularly compared to other means of acquiring the use of assets.
- Not neglect the fact that leasing is in many jurisdictions a regulated activity and should therefore take account of the needs of financial regulators who are an important category of users of lessor accounts.

This paper will assess the various models for lessor accounting against these criteria.

II. Industry's Position on Lessor Accounting: An Overview

General concerns on the current direction of the project

As stated in our comment letter to the Leases Discussion Paper, Leaseurope takes the view that the Boards have yet to make an adequate case for requiring a completely new lease accounting model that would apply to all leases. 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 and are simply used by businesses as a flexible solution to obtain the use of these assets. They are consequently far removed from the big ticket or structured leases that appear to be the focus of standard setters' concerns.

We do not believe that a new lease accounting model should be driven by the mistaken premise that companies use leasing solely as a structuring tool as this will lead to a final standard that will be indiscriminately and unnecessarily burdensome for all preparers. Indeed, the right of use model presented in the Discussion Paper is disproportionately complex for the large number of businesses who have many of these types of small ticket leases throughout their operations. Examples of complexity range from requiring firms to account for assets and manage asset registers whereas today they have straightforward operating expenses, to imposing significant burdens on businesses to estimate service components, calculate incremental borrowing rates, define probabilities related to their expected lease terms/contingent rentals and reassess all of these at each reporting date.

While our concerns relating to the complexity of the new approach for lessees are fully detailed in our response to the Leases Discussion Paper⁴, we think that it is particularly important to point out here that businesses opt for leasing as it offers them a degree of simplicity that other arrangements cannot convey. This is especially true of contract hire and full service lease contracts which will be particularly penalised as they include significant elements of service and are frequently subject to "recontracting" to adjust lease payments to actual usage. The burden of complexity will lie most heavily on lessees that use these types of leases as, under the proposed model, these companies will be required to account for their leases in a way that destroys the simplicity they are seeking by opting for these products in the first place.

Consequently, Leaseurope does not support the right of use model as presented in the Discussion Paper. Instead, we think that a more appropriate and time efficient manner of dealing with the criticisms of existing lessee accounting would be to stress correct application of the principles inherent in IAS17, harmonise definitions between US standards and IFRS by the removal of US GAAP bright lines and to improve the level of disclosures currently required under the current leases standard. Such an approach would then be reinforced through the external audit process.

The corollary of this view is that existing accounting for lessors would not need to be changed. Indeed, our preferred model for lessor accounting would be today's model as it has been proven to work in practice, is well understood by users and preparers and clearly recognises that there are different types of leases. Additionally, this approach results in a global lease accounting model that is coherent for both lessees and lessors.

⁴ See for instance pages 9-10 of our comment letter which can be accessed via the following [link](#).
Page 4 of 20 -

Lessor models under a right of use approach

If the Boards proceed with the development of a right of use model for lessees⁵, a new model for lessor accounting will need to be developed too⁶. Leaseurope considers that there is only one such model for lessors that is consistent with a right of use approach for lessees, namely the **de-recognition approach**. The underlying reasoning for this conclusion is set out below, together with a full description of the model.

In spite of stakeholder feedback⁷ that the de-recognition model should be applied for lessors, the Boards continue to pursue the development of the so-called performance obligation model, a model that is fundamentally inconsistent with their lessee model. If a lessor has the ongoing performance obligation to continue to permit the use of the leased asset as described by the Boards, then the lessee cannot have an unconditional obligation to make rental payments. The lessee's obligation is instead *conditional* on the lessor fulfilling its performance obligation and this does not meet the definition of a liability. If the Boards maintain that lessors have performance obligations, they will have no choice but to revisit the accounting model for lessees described in the Discussion Paper.

The performance obligation model also leads to the creation of multiple assets as, under this approach, lessors continue to recognise the entire value of their leased assets together with receivables for their rights to receive rental payments. In our view it is conceptually impossible to justify that an entity with one asset, generating one stream of economic benefits, when separating some of the rights attached to this asset and making these rights available to another party by virtue of a lease, would see its balance sheet virtually double in value. It is also difficult to understand why entities that write leases would have balance sheets twice the size of those that offer other forms of finance such as secured loans.

The artificial grossing up of lessor balance sheets created by the model will lead to a reduced return on assets and an increase in leverage for lessors. The result is that many shareholders of leasing companies may cease to see leasing as an attractive investment. Moreover, in the case of bank-owned lessors, the consequent increase of capital requirements resulting from inflated balance sheets may well lead to leasing no longer being considered as an attractive business proposition by their parents.

⁵ Leaseurope takes the view that significant simplification of many aspects of right of use model set out in the DP proposals is required in order to make a future lessee standard viable. The objective of this paper is not to go into details on what these simplifications should be; instead we refer the Boards to our [comment letter on the DP](#) for further information on our thinking in this area.

⁶ Please refer to [Leaseurope's comment letter dated 11 June 2008](#) for more information on the need to review lessor accounting if accounting for lessees is changed and why this should be done simultaneously.

⁷ See for instance the feedback of the Leases Working Group (September 2009 meeting and subsequent written feedback to staff), [Leaseurope's unsolicited comment letter to the IASB describing the outlines of a lessor accounting model](#) (23 October 2009) and responses to the Leases Discussion Paper where the majority of those constituents who commented on the Boards' high level questions on lessor accounting clearly were in favour of the de-recognition approach for lessors.

If many lessors reduce their operations or cease to operate as a consequence of applying the performance obligation model, the result will be that the European economy will be deprived of a vital source of funds. In 2008 for instance, European lessors were responsible for financing around 24% of all new European investments (excluding real estate)⁸.

We are aware that the Boards may consider some form of net presentation under the performance obligation approach. This would amount to a model under which lessor balance sheets would appear to be similar to accounting under the de-recognition model. Consequently, as the underlying principles of the performance obligation model are flawed, it would be much more appropriate to simply opt for the more correct de-recognition approach in the first place.

⁸ Leaseurope leasing penetration ratio estimate based on total new leasing volumes divided by total investment (excluding real estate) for the 23 countries and 30 members for which this data was available in 2008

III. The De-recognition Model

The entire right of use model developed for lessees rests on the Boards' analysis of the rights and obligations inherent in a simple lease contract. Indeed, the Boards concluded 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. As the lessor has performed, the lessee's obligation is unconditional and is therefore a liability that must be recognised in its financial statements. On the asset side, the Boards argue that the lessee has acquired an unconditional right to use the leased item for a certain period. Additionally, the lessee controls the right to use. It therefore recognises an asset for this right.

If one is to develop a coherent accounting model for leases where accounting for lessors is consistent with these conclusions for lessees, a lessor accounting model must therefore take into account the following facts:

- 1) The lessor has performed upon delivering the asset to the lessee. It does not have a continuing performance obligation to permit use of the leased asset throughout the contract and therefore cannot recognise a liability for such an obligation (as it does not exist)⁹.
- 2) The lessor has given up the right to use the leased asset to the lessee (it has been acquired by the lessee). This implies that an asset is a bundle of rights, some of which can be transferred (via a lease contract for instance). If some of these rights are transferred, the lessor has effectively given up some of the "value" of the asset i.e. it has foregone its entitlement to the future economic benefits associated with this right to use during the lease term. Such rights are clearly identifiable and separable. The lessor's measurement of the leased asset should reflect this situation¹⁰.
- 3) The lessor no longer controls the right to use the asset during the lease term. As it is the lessee that controls this right, in order to be consistent with the Basis for Conclusions in the Derecognition Exposure Draft which states that "two parties cannot control the same asset simultaneously"¹¹, the lessor cannot control this right and should de-recognise the part of the asset associated with the right.

A de-recognition model, whereby the lessor derecognises the leased asset to the extent of the rights it has transferred to the lessee and retains only its residual rights (if any)¹² is the only model which faithfully depicts the economics of a lease transaction in a way that is consistent with a right to use model for lessees.

⁹ This is reinforced by paragraph 3.19 of the Leases Discussion Paper which states that 'unless the lessee breaches the contract, the lessor has no contractual right to take possession of the item until the end of the lease term'.

¹⁰ This would also be consistent with the partial de-recognition approach under IAS 39, were the leased asset regarded as a financial asset.

¹¹ BC18, Exposure Draft ED/2009/3, Derecognition, Proposed Amendments to IAS 39 and IFRS 7

¹² The lessor could partially de-recognise the leased asset and retain a residual amount or fully de-recognise the leased asset and separately recognise a new asset for its residual rights.

The mechanics of a de-recognition model

Initial measurement

The lessor de-recognises the rights associated with the asset that it has transferred to the lessee. We note that the lessor will not have any difficulty identifying which asset it should de-recognise. Indeed, by definition, a lease is a contract that transfers the right to use a specific asset. If the asset is not specific, then the contract does not fall under the scope of lease accounting guidance.

After de-recognising the rights that have been transferred, any remaining value corresponds to the lessor's residual rights to use the asset once it is returned by the lessee upon completion of the lease term. This de-recognition is the counterpart for the lessee recognising an asset for its right to use the leased item.

The lessor has a right to receive rentals from the lessee that meets the definition of a financial asset (a contractual right to receive cash). This right is the counterpart for the lessee recognising a liability for its obligation to make lease payments¹³. The receivable should therefore be measured at the discounted lease payments using the rate inherent in the lease. This is consistent with accounting for other financial assets and, contrary to the lessee, the lessor will always know what the rate implicit in the lease is.

The amount corresponding to the lessor's residual rights is a tangible residual asset and is also equal to the present value of the projected asset value calculated using the rate inherent in the lease.

Subsequent measurement

The lessor's receivable should subsequently be accounted for at amortised cost using the effective interest method, consistently with other financial assets measured on this basis under IFRS 9 or the current IAS 39.

The residual asset is best described as being the leased item that is encumbered by the transfer to the lessee of the right to use this item. As the lease term progresses, this residual becomes progressively less encumbered (i.e. the lessor comes closer to reuniting all the rights associated with the asset). Subsequent measurement of the residual asset should reflect this progression and it should accrete at the rate inherent in the lease so that it equates to the expected asset value at the end of the lease term.

We recognise that other measurement issues will have to be addressed by the Boards, for example where there are changes in the projected residual value that may lead to revaluation or impairment and the basis upon which these would need to be recalculated.

Initial and subsequent measurement under this model are illustrated in the example below.

¹³ At this stage, we assume that the lease in question is a simple lease i.e. does not have any "complex" features such as options, contingent rentals, etc. We will address the issue of options and contingent rentals further in the paper.

Example 1. The De-recognition Model

Assumptions:

- Machine cost: €10,000.00
- Lease term: 5 years
- Payments: annual, in arrears
- Lessor's residual value: 10%
- Rate implicit in the lease: 10%
- Present value of the residual value: €620.92
- Amount to amortise: €9,379.08 (= €10,000.00 - €620.92)
- Rental payments: €2,474.18

Balance sheet		Initial	Y1	Y2	Y3	Y4	Y5
<u>Asset, of which:</u>	<u>10,000</u>	<u>621</u>	<u>683</u>	<u>751</u>	<u>826</u>	<u>909</u>	<u>1,000</u>
Leased Asset	10,000	0	0	0	0	0	0
Residual Asset	0	621	683	751	826	909	1,000
Receivable	0	9,379	7,843	6,153	4,294	2,249	0
<u>Total Assets</u>	<u>10,000</u>	<u>10,000</u>	<u>8,526</u>	<u>6,904</u>	<u>5,120</u>	<u>3,158</u>	<u>1,000</u>
<u>D&E (balancing #)</u>	<u>10,000</u>	<u>10,000</u>	<u>8,526</u>	<u>6,904</u>	<u>5,120</u>	<u>3,158</u>	<u>1,000</u>
P&L							
Interest			938	784	615	429	225
Interest on RV			62	68	75	83	91
<u>Net result</u>			<u>1,000</u>	<u>853</u>	<u>690</u>	<u>512</u>	<u>316</u>
RoA			10.00%	10.00%	10.00%	10.00%	10.00%

Revenue recognition

Given that the lessor's receivable is measured using the effective interest method, the lessor will always recognise interest revenue over the lease term, in total being the difference between the total rentals due over the lease term and the initial carrying value of the receivables. As lessors have sold the right of use of the underlying asset to the lessee, they should also be allowed to recognise sales revenue as described below

1) Third party lessors

In the case of third party leases, i.e. lessors which are not manufacturers of or dealers in the asset to be leased, the recognition of sales revenue should not arise. This is because, if a third party lessor (e.g. a bank or finance company) has purchased an asset to be leased onwards, there is a clear indication of the cost of the asset (i.e. the acquisition price). This cost would be used as the basis for calculating the right of use. It is therefore not possible to derecognise more than this cost, as this could only be achieved by discounting future rentals at a rate lower than the one used to calculate the rental payments. Provided the rate used to discount future rentals is the implicit rate of the lease, then third party lessors will have no sales margin to recognise (the sum of the receivable and residual will equal to the cost of the asset, as shown in example 1 above).

If an asset is recovered at the end of the lease term at its residual value and then leased a second time, the residual value should be used as the cost of the underlying asset, and the same reasoning applied.

2) Manufacturer/dealer lessors

In the case of a manufacturer/dealer lessor, the de-recognition model should lead to the recognition of a receivable and a residual (if any), the sum of these two amounts being greater than the manufacturing cost of the asset.

If the lessor has no residual, then it has effectively sold the physical asset. Such a case appears to be relatively straightforward and the lessor should recognise its full manufacturing revenue and cost of sales upfront. In other words, the manufacturer should make a profit that is equal to the difference between the arm's length (observable) retail price and the manufacturing cost of the asset.

If however the manufacturer has a residual interest in the underlying asset, it has sold a portion of the leased asset to the lessee that corresponds to the right to use this asset. As control of that right has been transferred to the lessee, the lessor should recognise any profit or loss on that sale upfront. The manufacturer should recognise an amount of revenue and cost of sale that is proportionate to the fraction of the underlying asset sold.

This is illustrated in example 2 on the following page.

Example 2. The De-recognition Model with Revenue Recognition for a Manufacturer Lessor

Assumptions:

- Machine cost: €8,750.00
- Machine sales price: €10,000.00
- Lease term: 5 years
- Payments: annual, in arrears
- Lessor's expected residual value: 30% (= 30% * €10,000.00 = €3,000.00)
- Rate implicit in the lease: 10%
- Present value of residual value: €1,862.76
- Amount to amortise: €8,137.24
- Rental payments: €2,146.58
- Full sales profit: €1,250.00 (= €10,000.00 - €8,750.00)
- Proportion of asset sold: 81.37% (= €8,137.24/€10,000.00)
- Initial sales profit: €1,017,15 (= 81.37% * €1,250.00)
- Portion of cost of sales: €7,120.08 (= 81.37% * €8,750.00)
- Unsold machine cost (residual value): €1,629.92 (= €8,750.00 - €7,120.08)
- Future value of the manufacturing cost (future RV) : €2,441.17 (= 81.37% * €3,000.00)
- Discount rate to obtain future RV: 8.41%

Balance sheet		Initial	Y1	Y2	Y3	Y4	Y5
Asset, of which:	<u>10,000</u>	<u>1,630</u>	<u>1,767</u>	<u>1,916</u>	<u>2,077</u>	<u>2,252</u>	<u>2,441</u>
Leased Asset	10,000	0	0	0	0	0	0
Residual Asset	0	1,630	1,767	1,916	2,077	2,252	2,441
Receivable	0	8,137	6,804	5,338	3,725	1,951	0
Total Assets		<u>9,767</u>	<u>8,571</u>	<u>7,254</u>	<u>5,802</u>	<u>4,203</u>	<u>2,441</u>
D&E (balancing #)		<u>9,767</u>	<u>8,571</u>	<u>7,254</u>	<u>5,802</u>	<u>4,203</u>	<u>2,441</u>
P&L							
Turnover			8,137				3,000
Cost of sales			-7,120				-2,441
Gross profit			<u>1,017</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>559</u>
Interest			814	680	534	373	195
Interest on RV			137	149	161	175	189
			<u>951</u>	<u>829</u>	<u>695</u>	<u>547</u>	<u>385</u>
Net result			<u>1,968</u>	<u>829</u>	<u>695</u>	<u>547</u>	<u>943</u>

Note: this is one approach to proportional revenue recognition, the Boards may wish to investigate other approaches.

This approach to revenue recognition under a de-recognition model for lessors:

- 1) Can be applied to all leases, i.e. there is no need to create an artificial distinction between leases that are sales and other leases
- 2) Is the only approach consistent with the Boards' conclusions for lessees that the lessee has purchased a right to use an asset¹⁴
- 3) Is consistent with the Revenue Recognition Discussion Paper where the right of use asset is considered to be a good and the "seller" has fulfilled its obligations to the buyer and the buyer accepts.
- 4) Is consistent with a manufacturer's business model where it sells equivalent assets for cash (or cash equivalent) consideration.
- 5) Is the only model where the lessor's fixed return on assets would be appropriately reflected. Indeed, for a given transaction where the terms are negotiated at the start and remain unchanged throughout the contract term, one would not expect any other return pattern than the constant, contractual yield.

Situations where the de-recognition model may not be practicable

In our view, a de-recognition model could in theory be applied to all types of lessors. Nevertheless, for daily rental companies (e.g. car rental firms), it would be an unnecessarily burdensome and disproportionate model to apply (de-recognising extremely small fractions of the physical asset, recognising receivables at the present value of rental payments, accounting for interest, etc.) and would not necessarily reflect the business model of such companies. The current operating lease model where the lessor recognises and depreciates the leased asset and where revenue is recognised as rentals are received should therefore continue to apply.

Under the daily rental example, it is clear cut that the operating lease model is the most practical and appropriate. That is, depreciating assets straight line over their useful life to their residual value (subject to impairment) and recognising income in the period to which it relates, will respect the substance of the transactions and the business's characteristics.

The Boards will however have to determine when it becomes reasonable for a lessor to start applying the de-recognition model. There will have to be a "cut off" and we appreciate the challenges that this would introduce. Nevertheless, while we are aware that the Boards prefer to have a single model that applies to all leases, we note that they are currently discussing various exemptions for short term leases. Whether there are two models for lessors within the scope of the lease guidance (a de-recognition model and today's model) or some lessors which are exempt from the standard would amount to the same accounting treatment in practice. Therefore, the Boards cannot avoid having to make such a distinction before finalising the standard.

We also recognise that one of the reasons the Boards have tentatively decided not to pursue the de-recognition model is that it does not function well in situations where fully depreciated assets still generate rental streams (the de-recognition model would result in a negative asset or deferred income in such cases). This will generally only happen however in situations where the underlying leased asset is held at amortised cost and has an extremely long useful life. This will typically arise in leases of land and buildings and will not be an issue if the assets are carried at fair value e.g. through allowing and

¹⁴ The Leases Discussion Paper clearly states that "in a lease contract the lessee has bought a right-of-use asset and is funding that acquisition with an obligation to pay rentals".



exercising a fair value option for these types of lessors. Property lessors should therefore apply the model in IAS40. Again, the Boards cannot avoid making some kind of distinction between different types of leases.

De-recognition: Consistency with high level principles for lessor accounting

A lessor accounting model should:	Assessment of the de-recognition model	Conclusion
Provide a true and fair view of a lessor's financial position.	As the de-recognition model is consistent with the principles below, we consider that it effectively provides a true and fair view of a lessor's financial position.	✓
Faithfully represent the economic reality of individual lease transactions in a way that is consistent with lessors' business models and reflects their exposure to risk.	<p>The de-recognition model recognises the fact that the lessor has performed its obligation to make the leased asset available upon delivery and is giving up a portion of this asset, the right to use the asset, to the lessee in exchange for rental payments. It also correctly reflects a lessor's constant return on its leased assets and performance measures (e.g. cost/income ratios) and does not distort its underlying leverage . It is consistent with the way management view their business.</p> <p>N.B. Daily rental and investment property businesses may be better catered for under current operating lease accounting and the IAS40 approach respectively.</p>	✓
Be simple for users to understand and for preparers to apply. In this context, a cost/benefit analysis must be carried out and prove conducive.	By correctly reflecting the economics of the lease transaction, we believe that this model will provide the information that users of lessor accounts, principally debt analysts, are looking for (return on assets, residual risk, etc.) and allow for meaningful comparisons with the accounts of other providers of asset finance. The model is based on how lessors manage their business and will therefore be simple for preparers to apply.	✓
Be conceptually consistent with accounting for lessees, other IASB projects and, more generally, with the Conceptual Framework.	This is the only lessor model that is consistent with the right of use model for lessees. It is also consistent with current projects such as the De-recognition and Revenue Recognition projects and with the Conceptual Framework.	✓
Not undermine the credibility or viability of leasing, particularly compared to other means of acquiring the use of assets.	The model does not disadvantage lessors compared to other forms of financing/purchasing of assets, contrary to the performance obligation model (see below).	✓
Not neglect the fact that leasing is in many jurisdictions a regulated activity and should therefore take account of the needs of financial regulators who are an important category of users of lessor accounts.	The model correctly reflects a lessor's risk profile (credit risk and asset risk) and does not create the balance sheet and consequent capital requirement distortions that arise under the performance obligation model (see below). It is therefore consistent with the needs of regulator users.	✓

IV. The Performance Obligation Model

The effects of a PO model with gross presentation

As already described, the European leasing industry is not in favour of any model under which lessors would recognise a performance obligation. This approach considers that the lessor has not given up control of the leased item. Yet, in reality, the lessor does give up control as it cannot ensure that it alone will economically benefit from the leased asset during the lease term. As the Boards have pointed out in the Leases Discussion Paper, the lessor is unable to recover or have access to the leased asset without the consent of the lessee (without breaching the contract).

Nevertheless, if the Boards are to pursue this approach, only a model that uses some form of net presentation would avoid the extremely negative effects that the grossing up of lessor balance sheets would have. These effects are described below.

For a given lease, a lessor using the performance obligation model with gross presentation would show a return on assets that would be approximately half of that shown under a de-recognition approach (see example 3 below). Moreover, the return pattern, instead of reflecting the lessor's constant rate of return, would be variable. As a result, a lessor's performance will be distorted and the accounting treatment will not reflect economic reality.

Other significant issues arise under the performance obligation model with gross presentation. The leverage of all lessors applying this approach will increase. Moreover, many European leasing firms belong to banking groups¹⁵. 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 their lease exposures, defined in a way similar to the current IAS17 notion of minimum lease payments. However, if in the future lessors have two assets for their leases, i.e. a receivable and the underlying asset, they will have to hold capital for both of these. Under current rules, this could lead to institutions having to effectively double their regulatory capital and, in some cases, the effect could even be higher. However, the risk profile of the lessor will not have changed. Again, accounting treatment will be providing a distorted view of the transaction.

Hence, there is *significant risk* that lessors having to apply this model will no longer consider leasing to be a viable business and will cease to operate in this market. This possibility is real and should not be underestimated. Yet leasing is a key source of finance for European businesses. The European leasing industry finances a significant amount of all new European investments. Moreover, it has been estimated that more than half of Europe's SMEs, the backbone of the European economy, have made use of leasing¹⁶. Changes in accounting standards that would lead to the provision of leasing ultimately drying up would therefore prevent many businesses from investing in and using assets. Clearly, this must be avoided at all costs.

¹⁵ According to Leaseurope's 2008 Ranking Survey of European leasing firms, 17 of the top 20 leasing companies in Europe are bank related.

¹⁶ SME Access to Finance, Flash Eurobarometer 174, TNS Sofres/EOS Gallup for the European Commission, October 2005

Example 3. The Performance Obligation Model with Gross Presentation

Assumptions (same as under Example 1):

- Machine cost: €10,000.00
- Lease term: 5 years
- Payments: annual, in arrears
- Lessor's residual value: 10%
- Rate implicit in the lease: 10%
- Present value of the residual value: €620.92
- Amount to amortise: €9,379.08 (= €10,000.00 - €620.92)
- Rental payments: €2,474.18

Balance sheet	Initial	Y1	Y2	Y3	Y4	Y5
Leased Asset	10,000	8,200	6,400	4,600	2,800	1,000
Receivable	9,379	7,843	6,153	4,294	2,249	0
Total Assets	19,379	16,043	12,553	8,894	5,049	1,000
Performance Obligation	9,379	7,503	5,627	3,752	1,876	0
D&E (balancing #)	10,000	8,540	6,925	5,142	3,173	1,000
Total Liabilities	19,379	16,043	12,553	8,894	5,049	1,000
P&L						
Interest		938	784	615	429	225
Decrease PO		1,876	1,876	1,876	1,876	1,876
Depreciation		-1,800	-1,800	-1,800	-1,800	-1,800
Net result		1,014	860	691	505	301
RoA		5.23%	5.36%	5.51%	5.68%	5.96%

Note: for subsequent measurement of the leased asset, we have chosen to depreciate the asset using straight line depreciation down to its residual value as in agenda paper 11A for the May IASB/FASB Board meetings.

Alternative approaches to net presentation under a PO model

In order to overcome the significantly detrimental side effects of gross presentation discussed above, Leaseurope has considered the following approaches to net presentation under a performance obligation model:

- 1) Net presentation of the performance obligation and lease receivable
- 2) Net presentation of the performance obligation and leased asset
- 3) Net presentation of the performance obligation, lease receivable and leased asset under a distinct balance sheet item.

We do not consider the first option to be viable as this may create a precedent for net accounting in general. It is not our understanding that the Conceptual Framework ever intended to encourage general netting of assets and liabilities. The second option would amount to very similar presentation on the balance sheet as the de-recognition model as it would reflect the residual value interest. As we consider the latter to be vastly superior, we cannot see why the Boards would simply not choose the de-recognition model as it better describes the realities of a lease transaction.

Our conclusion therefore is that if the Boards do continue with the performance obligation model, the only real alternative is the third approach. Ultimately, the underlying asset, receivable and “performance obligation” are intrinsically linked due to the existence of the lease contract. Indeed, the physical asset is the object of the lease contract and it is the lease that gives rise to the existence of the receivable and performance obligation according to the Boards. A cumulative approach combining all three under a “leases” caption on the balance sheet is therefore the least misleading. Disclosure of the individual components could be provided in the notes to the accounts in order to enhance a user’s understanding of them.

We have also noted that, in addition to balance sheet issues, the performance obligation model creates distortions in the P&L of lessors. For example, by not being able to de-recognise the leased asset, lessors would obviously have to hold and measure these assets and therefore recognise depreciation. This would negatively distort any operating expense ratios (e.g. the cost/income ratio for bank owned lessors) while bearing no reflection on the lessor’s real, underlying efficiency. Again, as with return on assets, measures of a lessor’s performance will be vastly different when the economics of the transactions they enter into are the same. We do not see that this would provide more meaningful information to users of accounts. Consequently, the Boards also need to consider P&L presentation. For instance, to overcome the increase in costs caused only by accounting treatment, lessors should be allowed to present their depreciation expense, interest income and decrease in the performance obligation in one P&L line with disclosure of the individual components in the notes. Similarly to our reasoning for net presentation in the balance sheet, this can be justified by the fact that all of these items are linked and arise out of the lease contract (see example 4).

Under a performance obligation approach, the Boards should also bear in mind that the lessee will be depreciating the right of use asset and the lessor the underlying asset. While these two assets are not exactly the same, the right of use asset does represent a significant portion of the leased asset. As a result, an important share of the economic costs of the asset would be recorded twice by different entities over the lease term, yet there is only one physical asset, generating one stream of economic benefits in existence. We think this is yet another example of how the performance obligation model does not faithfully represent the economics of the transaction.

Example 4. The Performance Obligation Model with Net Presentation (Cumulative Approach)

Assumptions (same as under Example 1 & 3):

- Machine cost: €10,000.00
- Lease term: 5 years
- Payments: annual, in arrears
- Lessor's residual value: 10%
- Rate implicit in the lease: 10%
- Present value of the residual value: €620.92
- Amount to amortise: €9,379.08 (= €10,000.00 - €620.92)
- Rental payments: €2,474.18

Balance sheet	Initial	Y1	Y2	Y3	Y4	Y5
Leases	10,000	8,540	6,925	5,142	3,173	1,000
<u>Total Assets</u>	<u>10,000</u>	<u>8,540</u>	<u>6,925</u>	<u>5,142</u>	<u>3,173</u>	<u>1,000</u>
D&E (balancing #)	10,000	8,540	6,925	5,142	3,173	1,000
<u>Total Liabilities</u>	<u>10,000</u>	<u>8,540</u>	<u>6,925</u>	<u>5,142</u>	<u>3,173</u>	<u>1,000</u>
P&L						
Net lease income		1,014	860	691	505	301
<u>Net result</u>		<u>1,014</u>	<u>860</u>	<u>691</u>	<u>505</u>	<u>301</u>
RoA		10.14%	10.07%	9.98%	9.82%	9.48%

Performance obligation: Consistency with high level principles for lessor accounting

A lessor accounting model should:	Assessment of the performance obligation model	Conclusion
Provide a true and fair view of a lessor's financial position.	The performance obligation model recognises an obligation that the lessor does not have as it has completed this obligation upon delivery of the leased asset. As there is no performance obligation, we do not consider that the model provides a true and fair view of a lessor's financial position.	x
Faithfully represent the economic reality of individual lease transactions in a way that is consistent with a lessor's business model and reflects a lessor's exposure to risk.	The model does not recognise the fact that the lessor has passed on a portion of the leased asset, the right to use asset, to the lessee. Moreover, under this model (both gross and net presentation) a lessor's constant rate of return is not reflected. With gross presentation its leverage is distorted and it appears to be less efficient due to increased operating expenses. Therefore, we do not consider that it represents the economic reality of a lease.	x
Be simple for users to understand and for preparers to apply. In this context, a cost/benefit analysis must be carried out and prove conducive.	The model will be extremely difficult for users to understand as it is difficult to link the different elements shown in the lessor's accounts with the economics of the transaction. Equally, users will not be able to see the lessor's constant rate of return. The model is also likely to be more complex for preparers to apply than the de-recognition model which is more familiar to preparers.	x
Be conceptually consistent with accounting for lessees, other IASB projects and, more generally, with the Conceptual Framework.	The performance obligation model is inconsistent with the right of use model for lessees and the De-recognition project.	x
Not undermine the credibility or viability of leasing, particularly compared to other means of acquiring the use of assets.	Under the performance obligation model with gross presentation, lessors will be disadvantaged compared to secured lenders: their balance sheets will have greater assets (approximately twice as high) and they will show lower returns. Lessors will appear to be less efficient than secured lenders.	x
	Under the performance obligation model with the net presentation approach suggested by Leaseurope, leverage and efficiency ratios will be less affected, however lessors will still not have constant rates of return.	x/√
Not neglect the fact that leasing is in many jurisdictions a regulated activity and should therefore take account of the needs of financial regulators who are an important category of users of lessor accounts.	Lessors' balance sheets will become severely inflated. This will have significant capital consequences for bank owned lessors.	x
	With net presentation, the balance sheet issue becomes less significant, although as it amounts to a similar result to de-recognition, it would be more logical to apply the latter approach as it better reflects the economics of the transaction. Whatever presentation approach is adopted under this model, it is unlikely that it will address the needs of financial regulators (or other users).	x/√

V. Accounting for Leases with Additional Features

Recently, the Boards have decided that lessors would account for features such as options and contingent rentals in the same way as lessees should under a right of use model.

In our response to the Leases Discussion Paper, we argue that a lessee should not be required to account for payments under optional periods or for contingent rentals that it has the discretion to avoid as neither of these meet the definition of a liability. Additionally, the proposed approaches for options and contingent rentals require the use of various estimation techniques that will be an immense source of complexity for preparers. In many cases, leases with these “complex” features are not entered into to avoid recognising assets and liabilities but rather as they simply provide the lessee with the flexibility to use assets in a way that best suits their business.

As we do not think that lessees have liabilities for their potential payments under optional periods and for some kinds of contingent rentals, we consider that lessors do not have corresponding assets for these elements. If anything, were this principle to be applied to lessors, it would result in accounting that is even more questionable than on the lessee side as lessors would be reporting assets they do not control. Such amounts would not in our view meet the Framework’s definition of an asset.

The Boards may wish to look into past cases of lessor bankruptcies (e.g. Atlantic Computer, Intel, Sound Diffusion) which could be attributed to an overstatement in assets (e.g. anticipated extensions did not arise). Despite the lessor undertaking regular review of recoverability and this being reinforced through the external audit process, in our view there still remains significant risk that lessors could report assets that only much later are deemed irrecoverable. Consequently, we are extremely uneasy with the method proposed and are of the opinion that users would not welcome such treatment. Our recommendation is therefore that lessors (and lessees) should only account for committed lease payments, whatever lessor accounting model is applied under a new standard.

VI. Conclusion

In accordance with our view that the existing accounting model for lessees should continue to apply (possibly with the adjustments described above), we consider that the existing IAS17 requirements provide the most appropriate accounting for lessors. Nevertheless, if the Boards decide that a right of use model should be used for lessees, the only lessor model that is consistent with this approach is the de-recognition model. Moreover, based on above analysis comparing different possible models to the fundamental principles set out in Section I, only a de-recognition model is capable of meeting these principles. We are not in favour of any model based on a performance obligation approach. However, if it is pursued, net presentation alleviates some of its distortive effects. Nevertheless, this effectively amounts to a de-recognition model, in which case we would argue that it is preferable to use the more conceptually correct de-recognition.