

A man with blonde hair, wearing a dark suit, light blue shirt, and red tie, is looking intently at a stack of five silver toy cars. He is holding the top car with his right hand and the second car with his left hand. The cars are stacked on a dark surface. The background is blurred, showing what appears to be an office setting with a window.

Accounting for the future

New developments and the business impact
of lease accounting under IFRS



Accounting for the future

Ask any fleet industry veteran and they will no doubt tell you that discussion around changes to the balance sheet treatment of leasing has been rumbling on for as long as they can remember.

Indeed, as far back as 1996, the Accounting Standard Setters of the G4+1, representing the major western economic powers, first issued a joint report in which a new approach to international lease accounting was discussed.

This report introduced the idea that operating leases, which up to that point had been treated under a ‘risks and rewards’ approach, might instead be examined under an ‘asset and liability’ approach.

Risk & rewards approach

This approach means that for the lessee, operating leases are treated as ‘off balance sheet’ because the lessor takes all the risks and rewards of asset ownership.

Asset & liability approach

This approach suggests that the lessee should reflect their rights and obligations under the terms of a lease - in other words their use of the asset - on the balance sheet.

At the time, there was little enthusiasm for such a change and a subsequent report in 2000 did little to alter this. It was not until 2002, when the Enron scandal put off balance sheet transactions under the spotlight, that momentum for change was renewed, especially with the SEC’s calls for greater transparency in the way assets were capitalised.

The culmination of these events was that in 2006, the IASB (responsible for IFRS) and its US counterpart, the FASB (responsible for USGAAP), renewed their commitment to the capitalisation of companies’ operating lease obligations.

Terminology

Accounting Standard Setters: IASB & FASB

IASB: International Accounting Standards Board

FASB: Financial Accounting Standards Board

IFRS: International Financial Reporting Standards

US GAAP: United States Generally Accepted Accounting Principles

SEC: Securities and Exchange Commission (United States)

G4+1: Association of the following accounting standard-setting bodies:

- Australian Accounting Standards Board
- Canadian Accounting Standards Board
- New Zealand Financial Reporting Standards Board
- United Kingdom Accounting Standards Board
- United States Financial Accounting Standards Board

Leaseurope: The European Federation of Leasing Company Associations

Consequently, a joint project was conceived with the objective to improve the transparency of financial accounting and reduce complexity, including specific attention for structured leasing deals. As a popular quote from inside the accounting boards goes, “*I want to fly on a plane that sits on somebody’s balance sheet!*”

The first tangible result of the two boards’ joint deliberations was a discussion paper, issued in March 2009, which is effectively the first formal step to a new international accounting standard for operating leases.



**“I want to fly on a plane that sits
on somebody’s balance sheet!”**

The thinking of the boards clearly embraces the *asset and liability* approach, whereby the lessee should include the value of the ‘right of use’ in its financial statements.

Under this principle, lessees could be required to record each car separately and to assess per financial statement date the assumptions underpinning the ‘right of use’ (i.e. the expected duration and usage for each individual asset). This value (asset) and the corresponding obligation to pay lease instalments (liability) would be included on the lessee’s balance sheet.

Why is accounting for leases important?

Assessing the impact of financial accounting standards is rarely straightforward and lease accounting is no exception. Certainly, the debate over balance sheet treatment is not as simple as an “off balance sheet is good” versus “on balance sheet is bad” argument.

In practice the impact of potential changes would vary from company to company, very much dependent on the specifics of their business.

Furthermore there is a difference in application and impact for different types of leasing. In this respect it is worthwhile to differentiate between the leasing of so called ‘big ticket’ items (such as aircraft or major plant equipment) and ‘small ticket’ items (such as outsourced vehicle leasing services).

In both cases, elements such as contract duration and level of usage may vary within a contract. However, for small tickets the number of assets is much greater.

Moreover, the required level of knowhow on the leased asset is more likely to be available within the lessee’s organisation if it concerns ‘big ticket’ leases (where the asset is core to the business) than in the case of ‘small ticket’ (where management of the asset is outsourced).



Notwithstanding this, the off balance sheet benefits of operating leases under the existing accounting standards can be overplayed. What is often forgotten is that full service operating leases also constitute a form of business outsourcing of which the financing element and associated accounting treatment are only small pieces of the jigsaw for many companies.

The benefits of no depreciation and no residual value risk, fixed budgeted costs, outsourced administration and maintenance, along with a host of other service elements typically covered within an operational leasing contract, should be taken into due consideration. Indeed, for many businesses they are primary factors in deciding how these assets will be funded and managed.

‘Big ticket’ leases

Structured finance approach

- main purpose to finance an asset
- applied by capital intensive industries (airlines, utilities, real-estate etc)
- the related asset (e.g. aircraft) is a part of the core business activity of the lessee (i.e. airline)

‘Small ticket’ leases

Outsourced services approach

- full operational lease and outsourced (non-core) services
- expertise and operational processes are with the lessor
- large quantities of assets with a relatively low individual monetary value (e.g. office equipment, vehicles etc)



Erik Henstra,
Global Coordination Director
of LeasePlan International,
comments on the relative impact of
possible changes in lease accounting:

“LeasePlan fully understands the objectives of the IASB and FASB to improve transparency and insight into financial accounts for its users, and to reduce complexity.

However, for full service leasing which is driven more by outsourcing objectives, the benefits of the revised accounting standards are not evident at this point in time. The proposed approach seems to be predominantly relevant to ‘big ticket’ items, where leasing is used as a structured finance solution for capital intensive industries.

With regards to the on- or off-balance sheet discussion, there is also the question of the size of the fleet in relation to the size of a business and its overall capital intensity. So, for example, a large manufacturing company or other capital intensive business might

have a relatively ‘heavy’ balance sheet and the effect of fleet vehicles and other ‘small ticket’ leases on the balance sheet might be considered negligible. For a professional services company with a relative ‘light’ balance sheet, the impact could be more material.

Furthermore, under a new standard it is likely that an operating lease, where the residual value is guaranteed by the lessor, would still result in a smaller balance sheet impact than a financial lease or direct purchase.

Even with some balance sheet capitalisation, lessees would still avoid the full asset value of fleet vehicles weighing on their balance sheet. What is more, the service benefits of full service operating leases remain integral to most organisations’ management of the fleet as both a business tool and an employee benefit.”

'Small ticket' items – a special case?

The fact that the finance element of a typical fleet leasing agreement only represents a part of the total package raises another important point in the ongoing debate.

The Accounting Standard Setters' long term desire to move operating leases on to the balance sheet has largely focused on the treatment of 'big ticket' business assets leased over longer term periods. As has been stated earlier, smaller and more numerous items such as fleet vehicles are quite different in nature.

Not only do contracts for 'small ticket' items often incorporate a service element in addition to finance, there is also a greater tendency for contracts to change mid term, early terminate or even extend. Indeed, this flexibility is an important part of the contract as it mitigates the lessee's level of financial commitment.

In the case of vehicle leasing, the fleet cannot be seen as one homogenous entity, as every vehicle is subject to an individual contract and its own set of circumstances.

In this sense, a potential change in accounting standards could prove difficult and time consuming to businesses in terms of financial administration. The finance element of every single vehicle, along with other small ticket items, would have to be separated, accounted for and adjusted on the balance sheet. At the same time, other contract elements would require separate booking in the profit and loss account.

“Even under the new standard, it is likely that an operating lease would still result in a smaller balance sheet impact than a financial lease or direct purchase.”





What is the current status of the Lease Accounting project?

With this project under way, it is still uncertain to what extent the accounting standards for leases will change. At this point in time it is also difficult to predict when these changes will be implemented, as it is one of many competing issues on the agenda of both boards and could easily get pushed down the list of priorities.

Another consideration is that the other side of the coin, that being how any changes would affect lessors' balance sheets, is yet to receive full consideration and could delay the process further.

However, to imagine that there will not be any changes would be unwise. The Accounting Standard Setters have continually stated their commitment to revising and converging their standards on lease treatment and it is most likely a case of when and how, not if, it will happen.

In terms of a stated timetable, following the consideration of comments by interested parties to the March 2009 joint discussion paper, the two accounting boards aim to produce an Exposure Draft by mid 2010. An Exposure Draft is considered to be the final draft of a new standard and is usually subject to a window of 3 or 4 months where further feedback and comment is invited.

The objective is to finalise the new standard in 2011, with a view on implementation in 2012. It is likely that time would be allowed for organisations to make the systems changes that would inevitably be needed to deal with accounting under a new standard, perhaps further pushing back the effective implementation date.



Mark Volmerink,
Group Financial Controller of
LeasePlan Corporation and member of
Leaseurope Accounting & Taxation
Committee, comments on LeasePlan's
input to date and likely future
developments:

“Throughout the process of consultation and discussion with the IASB and FASB, LeasePlan has taken an active role in representing the interests of its clients and the fleet industry at large.

LeasePlan included its reservations in a joint response made with two of our international competitors, which was sent to the IASB and FASB on 15 July 2009.

We have serious reservations towards the application of the proposed approach to full service leasing of smaller assets such as company cars. The proposed approach is very complex and labour intensive and could add a high level of subjectivity in the financial statements.

It could, for example, require lessees to record each car separately and re-assess the assumptions underpinning the ‘right of use’

(i.e. the expected duration and mileage for each car) in every regular financial statement.

In our view, the perceived reporting benefits of the current proposal would be very small in comparison to the significant increase in financial reporting workload for businesses and regardless, they would seem to bear little relevance when the assets, risks and services are outsourced to third parties like fleet management companies.

Our key concern is that no proper business impact assessment has been performed by the IASB and FASB so far. LeasePlan believes this is crucial to ensure that any benefits of a new approach are carefully weighed against the associated costs and complexity for businesses.”

On a wider scale, the SEC is pushing for full convergence of all international accounting standards by 2013, which suggests that there will almost certainly be change by this time.

What next?

What is clear is that those fleet industry veterans that have seen the debates on this topic come and go for well over a decade are unlikely to see an end to them quite yet. The Accounting Standard Setters have invited input from interested parties. So far there have been close to 300 reactions recorded. There is a generally shared concern among the respondents regarding the complexity and subjectivity introduced in the discussion paper, and a significant part of the respondents question the need for change. Undoubtedly there will be more discussions between industry and the two accounting boards before any final agreement is reached.

Via active participation in Leaseurope and in its own right, LeasePlan has engaged in the debate with other major leasing players and accountancy firms to voice the specific concerns surrounding vehicle leasing and to request that they are given due and serious consideration. Regardless of the ultimate outcome, it is worthwhile for our clients to consider discussing these developments with their Finance Department to learn how they are getting involved in this topic and how accounting for your corporate fleet and other leased assets (small or big) will fit into this.

Going forward, LeasePlan will remain actively involved in this project. We will continue to keep our clients up to date with related developments, and help them to prepare for the introduction of new standards when they emerge.

How LeasePlan can help

LeasePlan will keep you updated on related developments and the actions we are taking in this area via our LeasePlan Account Teams.

If you have any specific questions, your LeasePlan Account Manager will be happy to assist you.

How could your company get involved?

LeasePlan and other organisations are in active dialogue with the Accounting Standards Setters and through interaction with your LeasePlan Account Manager you can provide us with valuable input.

There is also an opportunity for you as a company to add weight to the discussions directly.

You can download the current and future discussion papers at: www.iasb.org (select: Projects → IASB Projects → Leases).

Once you have assessed the potential impact for your company and developed your opinion on the proposed standards, you can express your opinion to the Accounting Standard Setters (IASB/FASB) directly via the contact details provided on their website.



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