



# LEASE ACCOUNTING

CHANGE IS IN THE AIR!

**APRIL 2011**



*It's easier to leaseplan*



**IF YOU'RE MANAGING A FLEET OR YOU ARE A FINANCIAL PROFESSIONAL WITH ONE OR MORE LEASE CONTRACTS IN YOUR PORTFOLIO, YOU MAY BE INTERESTED TO HEAR THAT THE WAY IN WHICH YOUR COMPANY ACCOUNTS FOR THESE CONTRACTS IS SET TO CHANGE. AS YOU MAY KNOW, THE DEBATE ON CHANGES IN THE BALANCE SHEET TREATMENT OF LEASE CONTRACTS HAS BEEN RUMBLING ON FOR AGES. PERHAPS EVEN FOR AS LONG AS YOU CAN REMEMBER. IT NOW SEEMS THAT CHANGE REALLY IS IN THE AIR.**

## 1. WHAT'S THE PRESENT SITUATION?

To date, lease contracts have fallen into two basic categories: finance leases and operating leases. Under a finance lease, the leased asset is recorded on the lessee's balance sheet. With an operating lease, however, the asset does not appear on the lessee's balance sheet. This has made it relatively easy for companies to keep assets such as cars, ships, computer equipment and buildings off their balance sheets by leasing them under operating lease contracts and treating them as rentals. Indeed, keeping operating leases off their balance sheets is seen by some as one of the benefits of leasing.

The current approach is known as the 'risk and reward' approach, as the lessor is regarded as taking all the risks – and the rewards – of asset ownership (in case of an operating lease). Which is precisely why lessees are not required to treat the objects in question as owned assets. Instead, the monthly lease instalments are recorded as an expense in the income statement.

However, this system is perceived as providing less transparency for investors, shareholders, lenders and other stakeholders, who depend for their information on the financial statements published by the company in question. Information on operating leases cannot be obtained in an easy way from these statements. The standard setters argue that relatively similar types of leasing should not be treated in a fundamentally different way.



## 2. WHAT IS SET TO CHANGE?

### FROM OFF-BALANCE SHEET TO ON-BALANCE SHEET

Current accounting models have been criticised for failing to provide an accurate representation of lease transactions and hence for failing to meet the needs of readers of financial statements.

Responding to these criticisms, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) launched a joint project to develop a new, single approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts would be recognised on the lessee's balance sheet.

### RIGHT OF USE

If the new standard goes ahead as planned, all companies who prepare their accounts in accordance with the International Financial Reporting Standards (IFRS) or the

United States Generally Accepted Accounting Principles (US GAAP) will be required to adopt a 'right-of-use' approach in accounting for their lease contracts. The idea is that, under a lease contract, a lessee acquires a right to use an asset, and it pays for that right in the form of lease instalments. Lessees will be required to state their rights and obligations arising from lease contracts on their balance sheets.

Lease assets and liabilities will need to be recorded at the net present value of the future lease payments. Assets will be amortised (depreciated) over the full term of the lease. Liabilities (i.e. the obligations placed on the lessee to pay lease instalments) will be expressed on an annuity basis.

The proposed accounting model applies to all forms of leasing, including assets like buildings, photocopiers, IT equipment and ships as well as cars and other vehicles.

Anything, in fact, that's covered by a lease or rental contract.



### ARE THESE CHANGES FINAL?

No, these are proposed changes. Because of the fierce criticisms levelled at the model initially proposed by the IASB and the FASB, the two boards are likely to make concessions in a number of areas. See page 13 for more information on these expected changes.

#### The timetable for change

| 1996   | 2002  | 2006   | MARCH 2009  | AUGUST 2010  | Q1 2011  | Q3-Q4 2011   | 2013-2015  |
|--|---|--|---|--|--|--|--|
| The IASB first issued a joint report setting out a new approach to international lease accounting. | The momentum for change was renewed following the Enron scandal, which turned the spotlight on off-balance sheet transactions. The US Securities and Exchange Commission called for greater transparency in the capitalisation of assets. | The IASB renewed its commitment to the capitalisation of companies' operating lease obligations. | The IASB released a discussion paper on lease accounting, i.e. a first publication on a major new topic that is designed to explain the issue and invite comments from stakeholders. LeasePlan wrote one of the more than 300 'comment letters' that were sent in response to the discussion paper. The majority of these letters stressed the need for the IASB to simplify its initial proposals. | The next step came with the release of the 'exposure draft', i.e. the text of the proposed standard. Interested parties were given a period of four months in which to respond. The deadline for comments was 15 December 2010. Again, LeasePlan was one of the parties who commented on the exposure draft. | The IASB discussed the huge response to the exposure draft: over 770 comment letters were received. The IASB and the FASB decided to perform more outreach and fieldwork, including addressing the objections raised in the comment letters. | The final text of the standard is due to be issued in the second half of 2011. | The expected implementation date, i.e. the first full year of accounting in accordance with the new standard. It's important to bear in mind, though, that the IASB and the FASB have yet to set a formal implementation date. |

**Mark Volmerink**  
 Group Financial Controller of LeasePlan Corporation and a member  
 of Leaseurope's Accounting & Taxation Committee:



“The main change brought about by the proposed standard is that the distinction between finance leases and operating leases will disappear. All leases will now appear on the lessee’s balance sheet. As a consequence, costs will become less predictable: due to the different rules for classification and amortisation, there will no longer be a stable cost pattern over the life of the lease. Lease expenses will be higher at the start of a lease, and lower at the end. It’s only a question of timing, because the total cost of the lease will remain the same. The fact that costs are not stable over the life of the lease will make budgeting more difficult for lessees.”

“The standard is set to have a big impact on clients’ financial ratios – their debt will go up. Lease instalments will no longer be treated as ‘ordinary’ expenses in the income statement, but rather as amortisation and interest, which means they will appear in different line items. As a result, the cost of leasing will no longer be included in a key indicator like EBITDA. The latter will tend to rise.”

*The proposed changes for lessees*

| SITUATION TODAY          | ACCOUNTING PRINCIPLE  | RESULT  |
|--------------------------|---|---|
| Finance lease model      | The underlying asset and the related liability are recorded on the balance sheet.   | Investors can reliably use the financial statements as a source of information.   |
|                          | Interest and depreciation appear as expenses in the income statement.   |   |
| Operating lease model    | No assets and liabilities are recorded on the balance sheet.  | Investors need to adjust the figures in the balance sheet, either in an arbitrary way or with the aid of estimates which may or may not be accurate.                                      |
|                          | Operating lease instalments appear as expenses in the income statement.   |   |
| PROPOSAL                 | ACCOUNTING PRINCIPLE  | RESULT  |
| One model for all leases | A lease contract results in the lessee acquiring a right to use an asset, plus a liability to pay lease instalments. Both the asset and the liability are recorded on the lessee’s balance sheet. | The lessee’s financial statements provide investors and other readers with accurate information on the expected cash flows and liabilities relating to all the company’s lease contracts. |
|                          | Amortisation and interest appear as expenses in the income statement.   | These do not necessarily equal the lease instalments actually paid.   |



### 3. HOW ARE THE CHANGES GOING TO AFFECT YOU?

First of all, you will now need to state your lease contracts on your balance sheet. Your company's balance sheet will be lengthened as a result. This is inevitably going to affect a number of key financial ratios, such as your solvency ratio and your leverage ratio. The way in which lease expenses are recognised in your income statement will also change.

Second, life is set to become more complicated for the people who prepare and audit your accounts. In the future, lessees could be required to record each vehicle separately and to assess, as of the balance sheet date, the assumptions underpinning the 'right of use', i.e. the expected duration and usage of every individual asset.

Third, you will probably have to start doing a bit of guesswork. Or 'probability assessments' to use the correct term. For example, as a lessee, you'll be required not only to estimate the likely term of each lease contract you sign (irrespective of what the contract actually says), but also to periodically review your

estimates, in principle at each reporting date. The term of the contract is regarded as being 'the longest possible term that is more likely than not to occur'. In making your estimate, you should take all relevant factors into account, including non-contractual and business factors, as well as your intentions and past practices.

Other areas in which you may be required to make some educated guesses relate to contingent rentals, residual value guarantees and term option penalties.

Fourth, you may need to take a look at your internal controls and processes. The need to start recording lease contracts on your balance sheet and to perform periodic reassessments of your lease terms and payments may force you to make major changes to your processes and internal controls.

Fifth, the new model may affect the tax treatment of lease contracts. However, this will vary from one country to another.

*The new standard will affect both the classification and the timing of expenses (for lease contracts currently classified as operating leases)*

- (i) Under the current accounting model, lease expenses are generally recognised as 'overhead expenses'. Under the proposed model, however, these will fall into two categories: 'amortisation charges' and 'interest expenses'.
- (ii) The timing of expense recognition will change as lessees will now have to recognise amortisation charges and interest expenses rather than the actual value of their monthly lease instalments. These are not necessarily the same. In other words, the monthly lease instalments charged by LeasePlan will remain stable throughout the life of the contract. However, the expenses as stated in the income statement will be higher than the actual lease instalments during the first half of the lease, and lower during the second half of the lease. This feature is known as 'front-loading'. It does not affect the aggregate value of the expenses over the entire duration of the lease, which remains exactly the same.

### 4. WHAT IS LEASEPLAN'S VIEW?



Besides looking for solutions for our clients, LeasePlan is also trying to influence the outcome of the discussions on the new standard. We were one of the more than 770 organisations that submitted a comment letter and raised our objections to certain aspects of the standard.

We support the joint efforts of the IASB and the FASB to harmonise the accounting treatment of leases. We also recognise the need for greater transparency and agree to the concept that all lease contracts are recognised as rights and obligations explicitly in the financial statements of lessees. However, we have strong reservations against the application of these principles, as proposed in the exposure draft. Our main concerns in relation to lessee accounting are the following:

- The measurement of the rights and obligations is too complex and requires too many subjective assessments
- We do not support the proposed income statement approach which results in front-loading of expenses
- With respect to transition, we think a full retrospective approach should be allowed

Read the full text of our comment letter on [www.ifrs.org](http://www.ifrs.org).

**Jochen van den Berg**  
Global Project Manager for the lease accounting project at LeasePlan Corporation:



“Clients have been asking us what’s going on, and what we can do to help them. We’d like to make clear to everyone that this is an issue we’re working on. Even though the final text of the standard has yet to be agreed, we’re doing our best to keep up with everything that’s going on, and are investigating the type of solutions we can provide. What we expect our clients to need is more accounting information, based on the new standard. Which is why we are looking very closely at the requirements in the exposure draft. We’re working on solutions that should enable our clients to obtain the information they need for their accounting purposes. We’re currently examining the technical possibilities, and I’m confident that we’ll be able to deliver.”

“At the same time, we’re also trying to influence the outcome of the debate on the new standard. We were one of more than 770 organisations to submit a comment letter and raise objections to certain aspects of the standard, in the hope that these will be simplified, thus making life easier for our clients.”

## 5. IT ALL SOUNDS A BIT OF A NIGHTMARE – DO I NEED TO START WORRYING?

No, there’s no need to worry. It might be a good idea to start planning, though.

Yes, your financial ratios will be affected, but leasing will remain an attractive option. After all, with the new standard affecting all companies working with IFRS or US GAAP in the same way, the playing field will remain just as level as it was. Moreover, the amounts capitalised under lease contracts will still be lower than under outright ownership. LeasePlan’s aim in life is to make running a fleet of vehicles as easy as possible for you, whether you’re a fleet manager, a finance director or a controller. That’s why we’re already thinking about ways and means of supplying you with the information you will need to prepare your accounts in accordance with the new standard. We’ll let you know as soon as we have more definite information. We’re going to keep a close track on the standard as it evolves, alert our clients to whatever changes are in the pipeline and provide them with all the information they need to prepare their accounts in line with the new requirements.

Moreover, the standard is far from set in stone yet. The IASB and the FASB have been swamped with comments from both inside and outside the industry – over 770 in total – and are doing their best to assess these in the first half of 2011. It seems likely at the time of writing that the new standard will undergo a number of major revisions before the final

version is published. Among the items at which the most criticism has been levelled are the need to estimate lease contract terms and the issue of contingent features – the amounts payable by lessees under residual value guarantees and term option penalties. These are precisely the aspects that are likely to prove the most time-consuming and complex.

One thing seems clear, though: the principle of taking lease contracts onto the balance sheet is here to stay. But despite the accounting changes in the offing, leasing remains attractive as it continues to offer many advantages over outright ownership:

- A full-service operating lease means that the lessor deals with administration and maintenance, as well as providing various other services, e.g. driver services, roadside assistance, communication, etc.
- An effective source of finance, especially for those companies whose borrowing options are otherwise limited
- Predictable fixed costs = reliable budgeting and forecasting
- No residual value risk
- Tax efficiency
- Operational flexibility: an opportunity to change contracts mid-term
- Even with some degree of balance sheet capitalisation, the full asset value of leased vehicles and equipment still weighs less on your balance sheet than if you had purchased them outright

**John Houtsma**  
Global Coordination Director of LeasePlan International:



“Operational leasing will remain just as attractive as it is now for companies who are interested in the huge benefits offered by the service component - the convenience of getting someone else to take over the full responsibility for managing your fleet of vehicles as well as taking over the risk of maintenance costs and residual value.”

“The financing benefit will also remain - you get to invest your money in your core business rather than in cars. The main change is that accounting will be different.”

## WHAT CHANGES MAY YET BE MADE TO THE NEW STANDARD FOR LESSEES BEFORE PUBLICATION?

Some of the areas that have attracted the fiercest criticism from the industry and on which the IASB may yet withdraw or amend its proposals are those affecting issues like the assessment of lease terms, contingent rentals, residual value guarantees from lessees, and term option penalties. These are all time-consuming aspects that will require a great deal of guesswork without actually generating any additional information value.

The most striking feature of the response was the huge ‘thumbs down’ for the proposal to bring lease continuation options onto the balance sheet. The IASB proposed to require this on the basis of ‘the longest period for which it is more likely than not that a lease containing renewal options would be continued’. This principle was overwhelmingly rejected by respondents of all types.

The accounting standards boards have discussed the proposed changes during the past few months. Further discussions will follow in the months ahead. There would now appear to be a general consensus that the proposals for the treatment of the lease term, options and contingent rentals need to be changed. The boards are also investigating whether expenses could be recognised on a straight-line basis for certain types of leases.

Tentative decisions have been taken about alternative approaches. These are not yet final, however, so it remains unclear as to whether they will actually be incorporated in the final standard.

The anticipated changes which are most relevant for you have been indicated in the table below (updated until 15 April 2011). The official release of the final standard is expected in the second half of 2011. There is also a chance that there will be a re-exposure of the draft leasing standard.

| TOPIC  | EXPOSURE DRAFT  | LATEST PROPOSALS  |
|--|---|---|
| Expense recognition                              | Front-loading of expenses                                       | Two types of leases identified: <ul style="list-style-type: none"> <li>• Finance leases, in which the financing element is significant. Income recognition on an annuity basis as proposed in the exposure draft</li> <li>• Other-than-finance leases: straight-line expense recognition similar to today’s model for operating leases (no more front-loading)</li> </ul> |
| Lease term                                       | Longest possible term that is more likely than not to occur     | Contractual minimum lease term plus any optional periods that are reasonably certain  |
| Contingent rentals (i.e. over- or under mileage) | To be included on a probability weighted expected outcome basis | In substance disguised fixed minimum lease payments   |
| Effective date                                   | Earliest possible date: 1 January 2013                          | To be decided, but 1 January 2015 is expected   |

## 6. IS THERE ANYTHING YOU CAN DO TO PREPARE FOR THE NEW STANDARD?

There are six things you need to start thinking about:

1. Anticipate the changes in your financial ratios
2. Start an internal dialogue with your finance and accounts departments. When the standard becomes effective, your figures for the previous year will also need to be prepared in accordance with the new standard in order to enable comparison
3. Gather and review all your lease contracts. Decide whether these provide sufficient information for preparing your accounts in accordance with the proposed standards
4. Consult your lease suppliers about the type of information you will need from them
5. Be ready to adjust your systems and processes once the final standard is published
6. Don't forget that the new accounting model will not apply simply to cars and other vehicles. It applies to all forms of leasing. In other words, assets like buildings, photocopiers, IT equipment and ships are also covered. In fact, anything for which you take out a lease or rental contract

### Glossary of terms

|                                 |   |
|---------------------------------|---|
| <b>AMORTISATION</b>             | The writing off or reduction in value of an asset over time.  |
| <b>CONTINGENT RENTAL</b>        | A lease instalment that arises during the term of a lease because of changes in circumstances (other than the mere passage of time) after the commencement of the lease. Payments for extra mileage are a good example of a contingent rental.  |
| <b>EBITDA</b>                   | Earnings Before Interest, Tax, Depreciation and Amortisation.   |
| <b>FASB</b>                     | Financial Accounting Standards Board.   |
| <b>FRONT-LOADING</b>            | The amount stated for expenses in the income statement is higher at the start of the lease than the amount actually paid in practice, whereas the reverse is true towards the end of the lease: the amount stated in the income statement is lower than the amount actually paid.   |
| <b>IASB</b>                     | International Accounting Standards Board.   |
| <b>IFRS</b>                     | International Financial Reporting Standards, issued by the IASB.  |
| <b>LEASE CONTRACT</b>           | A contract in which a right to use a specified asset (known as 'the underlying asset') is conveyed for a specified period of time, in exchange for consideration in the form of lease instalments. This definition is important in deciding whether a contract should be treated as a lease (and therefore be subject to the new accounting standard) or as a service contract. |
| <b>LEVERAGE RATIO</b>           | The same as the 'capital gearing ratio', i.e. the ratio of debt to equity in a balance sheet. It is both a measure of the extent that debt has been used to fund the assets of a business, and also the risk inherent in the firm's capital structure.  |
| <b>RESIDUAL VALUE GUARANTEE</b> | The lessee is required to state an amount in respect of residual value guarantees where it has been agreed that the lessee takes the residual risk value of certain vehicles. The amount quoted in the accounts consists of the difference between the asset's fair value (i.e. market value) and book value.   |
| <b>SOLVENCY RATIO</b>           | A company's ability to meet its long-term obligations.  |
| <b>US GAAP</b>                  | United States Generally Accepted Accounting Principles, issued by the FASB.   |

## FURTHER INFORMATION

For further information on the new standard, visit [www.ifrs.org](http://www.ifrs.org).

The IFRS project page contains links to the FASB leasing web page, a snapshot summary of the exposure draft, a comment letter summary, a series of project podcast and webcast recordings, and Q&As. You can also register for free email alerts.

If you have any queries about the new lease accounting standard, please contact your LeasePlan Account Manager who will be more than pleased to help.



*It's easier to leaseplan*

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