



FINANSBOLAGENS FÖRENING
THE ASSOCIATION OF SWEDISH FINANCE HOUSES

European Commission
Jeroen HOOIJER – Head of unit F3
Directorate – General Internal Market and Service
B – 1049 Brussel
Belgium

Stockholm, 8 March 2011

Accounting for leases is moving in the wrong direction

Leasing is of great significance to the supply of capital and investments and sales

In Sweden, as in the rest of the EU, leasing and renting of just about everything from equipment to commercial premises has long been a well established feature of the business world, which works well and provides effective use of resources and flexibility. Leasing is an important tool in connection with both investments and the sale of goods and services, in the EU and in other countries where European companies operate and offer their goods and services.

As to statistics, there are no aggregated figures on how different types of entities make use of leasing and renting in Sweden or the EU as a whole. Leasing and renting is of particular significance to SMEs, but is widely used by all types of entities. A fair estimate is that leasing represents the business community's largest source of external financing, and in Sweden accounts for around 20 per cent of all new investments in machinery and equipment. With regard to new vehicles, it is estimated that 60 per cent are financed by leasing in Sweden. The value of new leased assets financed through Swedish MFIs (monetary financial institutions, i.e. banks and credit market companies which are finance companies) totalled nearly SEK 85 billion in 2010. The book value of the lease stock totalled just over SEK 190 billion, of which just under SEK 60 billion pertained to foreign lessees.

The Swedish statistics above do not include leasing offered by so called financial institutes (not under full supervision) or leasing or renting of movable property offered by "ordinary" companies in the form of sales-support financing or as an element in customer offerings which may also contain services. In addition, there is the leasing and renting of commercial premises. For companies operating internationally and the export industry there are in addition to this also other markets where sales are made or operations are undertaken. All together, these represent considerable

economic values for Sweden alone, where the figures quoted can be likened to the tip of the iceberg. Equivalently, in a wider EU-perspective, inconceivably economic values are involved.

To sum up, leasing and renting is of great significance to the supply of capital and investments and sales throughout the EU.

The development of a global regulatory framework for accounting in listed companies is positive

Consolidated financial statements for listed companies in Europe have to comply with standards issued by the International Accounting Standards Board (IASB) and adopted by the EU under what is known as the IAS Regulation (1606/2002/EC). The IASB has cooperated with the American Financial Accounting Standards Board (FASB) in recent years with the aim of drawing up a common global accounting regulatory framework. The business world supports the trend towards a global accounting regulatory framework for listed companies. One of the most important areas for review by the IASB and the FASB is accounting for leases.

The present-day accounting model for leases works well

The accounting of leases in listed companies today follows IAS 17.¹ Leases are recognised as finance leases or operating leases for both the lessor and lessee, depending on the substance of the contracts. The business world and the companies that offer or make use of leases and rentals have adapted to the present-day accounting model. It is considered to work well in Sweden and the rest of the EU.

The IASB's proposals for changes to the accounting of leases show serious deficiencies and cannot form the basis for a new financial reporting standard

The IASB and the FASB have been working on the development of a proposal for a joint standard for leases for several years. The overarching aim is to improve information for users of the financial reporting. The principal reason behind the proposal is, however, to limit the circumventions of the current standard for leases in US GAAP. The idea which the IASB and the FASB have come up with in order to address this problem is to change the accounting treatment so that all contracts have to be accounted for as finance leases for lessees.

The IASB's Exposure Draft ED/2010/9 Leases was presented in August 2010, and according to the IASB's work plan due to be adopted as a standard during the second quarter of 2011.²

PwC in the Netherlands, together with the Rotterdam School of Management, Erasmus University, conducted a survey of companies' reaction and attitude to the proposed new lease standard in 2010.³ The survey is based on responses from 125 CFOs in IFRS-reporting companies around Europe. The results of the survey can be summarised as follows:

¹ The principal features of the accounting model are described in Annex 1.

² The principal features of the proposal according to IASB ED Leases are described in Annex 2.

³ Concerning the survey, see: <http://www.pwc.com/cz/en/leasing/assets/PwC-Lease-Accounting-European-Impact-Survey.pdf>

- European companies are not yet ready to implement the new lease standard
- The impact of the new standard on results may come as a surprise
- Key financial ratios and terms of lending may be affected
- There is a fear of high implementation costs and costs of compliance with the new standard
- Significant changes may arise in the lease market

The proposal from the IASB has been met with strong criticism from a large number of stakeholders, and many oppose the proposal. Some common criticisms levelled at the proposal are that:

- The IASB is not attaining its targets for the project
- The proposal is not prepared with sufficient thoroughness and endorsement from stakeholders
- The proposal does not fulfil the requirements of high quality in financial reporting standards
- There is no impact assessment

We share much of the critique levelled against the proposal.⁴ The essence of our criticism is that we consider that all the information, including that contained in notes to the accounts, is already available to the users of financial statements.⁵ We therefore do not see any need to force through a new standard without a proper and thorough impact assessment.

The IASB and the FASB are now, after the ED, attempting to resolve several fundamental issues, for example the definition of lease and service contracts. The changes so far discussed by IASB and the FASB are so significant that they in fact amount to a "new" proposal. This further stresses the need for thorough impact assessment and a re-exposure before the IASB and FASB makes a decision to issue a new standard.

What should the Commission do?

The Commission should make it clear to the IASB as soon as possible that a proper and thorough impact assessment is required and that the stakeholders should be granted an opportunity to respond to a more thoroughly prepared proposal (re-exposure) before the IASB makes a decision to issue a new lease standard. It should also be clarified that this is deemed necessary before a new lease standard can be adopted for application in the EU.

The Commission should, in addition, conduct its own impact assessment as soon as possible.

The Commission should furthermore revise the rules on capital adequacy if the future lease accounting policies have undesirable effects on the capital adequacy situation of financial entities. This is also an issue which should be addressed and resolved at the international level.

⁴ Our criticism is developed in Annex 3.

⁵ Example of note on leasing:

http://www.ericsson.com/thecompany/investors/financial_reports/2009/annual09/results-notes-to-the-consolidated-financial-statements-c27-leasing.html

Association of Swedish Finance Houses Swedish Bankers' Association Conf. of Swedish Enterprise

Tom Ekelund

Kerstin af Jochnick

Claes Norberg, LL.D

Chief Executive Officer

Chief Executive Officer

Professor, Director Accountancy

Annex 1

The present-day accounting model for leases according to IAS 17

Lease according to IAS 17 is a very wide-ranging term, among other things covering ordinary rental contracts for immovable and movable property. The standard covers everything from rental of premises and industrial equipment to cars, photocopiers and coffee machines.

The standard, in brief, means that both lessees and lessors have to classify leases in their accounting as either operating or finance leases. A finance lease is defined as a lease that substantially transfers all the risks and rewards incidental to ownership of an asset from the lessor to the lessee. Legal title may or may not be transferred to the lessee. A contract which is not financial is an operating lease.

Lessees have to account for finance leases as assets and liabilities in their balance sheets, despite the lessee not having legal title to the asset. In the subsequent measurement, the lessee accounts for depreciation of the asset and interest expenses for the liability. At the lessor, a finance lease gives rise to a receivable in the balance sheet. Payments received are recognised both as payment of the receivable and as financial income.

In the case of operating leases, the lessee recognises the lease payments as an expense during the contract period in the same way as rental expenditure. The lessor recognises the object of the lease as an asset in its balance sheet and depreciates the asset. The lease payments are recognised as rental revenue during the term of the contract. A distinctive feature of operating leases is that both legal and “economic” title rest with the lessor.

Annex 2

The IASB's proposal for changes to the accounting model for leases

In 2010 the IASB issued a proposal for changes to the accounting of leases, Exposure Draft ED/2010/9 Leases. The proposal, in brief, signifies the following material changes in relation to IAS 17.

The present-day division into finance leases and operating leases is abolished for the lessee. Instead, all contracts are to be recognised as though they were finance leases. The value of utilising the asset is recognised by the lessee as an asset and the obligation to make payments under the lease is recognised as a liability. The recognised lease liabilities of entities will therefore increase.

It is further proposed that lessees should take account in the valuation of a lease liability of both contingent rentals (for example based on future turnover) and renewal clauses, which means that entities may be forced to make estimates of the probability of renewal options being utilised far into the future. This will also lead to an increase in recognised lease liabilities.

With regard to lessors, it is proposed that a model similar to the present two-part model be introduced. This therefore means that, unlike the situation today, accounting will be asymmetrical for the lessor and lessee.

Regarding the proposal from the IASB, see also:

<http://www.ifrs.org/Current+Projects/IASB+Projects/Leases/ed10/Ed.htm>

Annex 3

Our criticism of the process

When the project was adopted for the joint agenda of the IASB and the FASB in 2006, the level of ambition at first was high. The objective was to develop a completely new standard for both lessees and lessors in 2011. In order to keep to the tight schedule, the IASB and the FASB decided some time into the project only to draw up a proposal relating to the accounting of lessees/tenants. The proposal was presented in a Discussion Paper (DP) in 2009. The widespread criticism that followed the proposal led to few substantive changes. On the other hand, the IASB and the FASB resumed work on the accounting of lessors under even greater time pressure.

The IASB and the FASB are now, after the ED, attempting to resolve several fundamental issues, for example the definition of lease and service contracts. The changes so far discussed by IASB and the FASB are so significant that they in fact amount to a "new" proposal. This further stresses the need for thorough impact assessment and a re-exposure before the IASB and FASB makes a decision to issue a new standard.

To summarise, the IASB and the FASB have so far not attained the objective of producing a thoroughly prepared and high-quality proposal for an international accounting standard for leases and rentals. There are several explanations for this. Some factors are as follows:

- An unrealistic timetable
- Prominent members of the IASB and the FASB at an early stage locked themselves into a completely new model for the accounting of lessees/tenants instead of considering views expressed by stakeholders
- The IASB and the FASB "skipped" presenting a proposal to both lessees and lessors in the Discussion Paper, with the result that there has not been a basis for a thoroughly prepared and endorsed Exposure Draft

Our substantive criticism

1. The proposal is excessively focused on preventing circumvention and has a very negative impact on the reporting of commercially reasoned leases. Abuse in the United States should not be a reason for foisting a poorly formulated standard onto Europe.
2. The proposal does not, like the current rules, take account of there being different commercial reasons for entering into lease contracts. Not all contracts are financial in nature. An important aspect which has not been taken into consideration is that entities choose to lease instead of buying property in order to have operational flexibility.
3. There is a risk of the proposal affecting commercial decisions instead of the accounting reflecting the commercial decisions which have been taken by the entity.
4. Parts of the proposal are highly complex and difficult to apply. There is no analysis of costs and benefits in the proposal. Our view is that the costs will increase substantially for entities, without a corresponding increase in benefit to the users of the accounting. The proposal is consequently at odds with the need for regulatory simplification.

5. The new model will create new problems in distinguishing, for example, between service and lease contracts and between the various models to be applied for lessors.
6. The proposal to take account of contingent rentals and renewal clauses is at odds with the definition of liability in the IASB Framework. In addition, the information demanded generally cannot be established in a reliable manner.
7. The proposal will lead to increased indebtedness for entities. An example that can be mentioned is the Swedish fashion retail store chain KappAhl, whose balance sheet is estimated to double in size even if renewal options are not included. If, in addition, the renewal options are included, the effect becomes even greater. However KappAhl's situation is not in any way unique. It's just the standard leasing of retail premises that create the effect. And the effect is unavoidable as retailers can't buy and own their retail premises located in shopping malls, city centers etc.
8. If the proposal is implemented, it will in many cases lead to accounting of the same asset for both the lessor and the lessee. The total volume of assets in entities may therefore be wrongly inflated.
9. Leasing is an important source of finance for entities. The risk with the proposal is that it may lead to a reduced supply, higher costs and greater complication of financing, which may adversely affect not only listed companies but also small and medium-sized enterprises (SMEs), i.e. the proposal has a knock-on effect on SMEs.
10. The proposal is poorly adapted for example to leases pertaining to commercial premises. The accounting of costs will be substantially distorted for tenants/lessees compared to the situation today.⁶
11. The proposal may have negative consequential effects in other areas. The effects on the capital adequacy requirements for financial entities, for instance, need to be analysed. We do not know with certainty how the proposed accounting policies for leasing may affect the rules on capital adequacy. However, at least two alternative outcomes appear likely. One outcome may have substantial negative effects on the capital adequacy situation of entities.⁷

See also regarding our response to the IASB consultation

The Association of Swedish Finance Houses and Swedish Bankers' Association (including response to EFRAG):

[http://www.swedishbankers.se/web/bfmm.nsf/lupgraphics/IASB101129.pdf/\\$file/IASB101129.pdf](http://www.swedishbankers.se/web/bfmm.nsf/lupgraphics/IASB101129.pdf/$file/IASB101129.pdf)

[http://www.swedishbankers.se/web/bfmm.nsf/lupgraphics/EFRAG101125.pdf/\\$file/EFRAG101125.pdf](http://www.swedishbankers.se/web/bfmm.nsf/lupgraphics/EFRAG101125.pdf/$file/EFRAG101125.pdf)

Swedish Enterprise Accounting Group at the Confederation of Swedish Enterprise:

⁶ See also Annex 4 for an illustration of the effect of the proposal.

⁷ We expand on the problems in Annex 5.

http://www.svensktnaringsliv.se/multimedia/archive/00025/Remissvar_2010-257_25236a.pdf

We also wish to refer to the consultation response from the Swedish Financial Reporting Board:

http://www.radetforfinansiellrapportering.se/UserFiles/filarkivet/7/3Aktuella/RFR-rs%202010.18%20Publ_underl_%20Exposure%20Draft%20Leases%20ED_2010_9_underskr_AU.pdf

All responses to the IASB – including responses from the European Banking Federation (No 715), Leaseurope (No 449) and Business Europe (No 716) – see:

http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1850-100

Annex 4**Accounting of leases regarding commercial premises according to the IASB proposal**

According to a type of lease in common use today, the rental for commercial premises increases in line with an index, which may, for example, be related to turnover. Ten years from now, turnover in the store may perhaps be 50% higher than it is today. This means that the recognised income and expenses for the premises will develop at the same rate, and this is also reflected in present-day accounting in accordance with IAS 17.

Under the new leasing proposal, on the other hand, lessees would be compelled to recognise a high rental at the start of a contract period and a low rental towards the end. The financial result for a store will thus be poor at the start and very good at the end of a rental period. This is at odds with the fundamental principle of matching costs against revenue. It will not facilitate understanding of the activity if an individual store recognises a lower rental expense in 10 years' time than it does today.

Annex 5

Capital adequacy of properties and commercial premises

Introduction

IASB ED Leases may have a negative impact on the attractiveness of leasing as a form of financing and therefore the opportunities of the lessor to pursue its operation. The ED may also affect the situation of companies as lessees in some parts of their operation, such as in the renting of properties/office premises. The question has therefore arisen as to how the companies' properties and premises (the bank's branch business) in which the company carries on its operation may have an impact on the capital adequacy situation of companies. The financial entities covered by rules on capital adequacy comprise banks, credit market companies and securities companies. The capital adequacy rules cover both individual institutions and financial groups of companies. The risks covered by the rules are credit, market and operating risks.

This annex disregards other types of holdings of properties which the company have, such as properties taken over for the protection of the receivable, properties owned through companies and what are known as properties for investment.

A conceivable classification in the accounting of properties/premises assuming that the ED becomes a new IFRS standard

This analysis is based on the company having disposed of its properties and then leased them back. The contracts are constructed such that they are classified as operating leases under the present-day rules.

The IASB ED contains requirements for the companies, in supplementary disclosures to the balance sheet, to present a breakdown between properties which the company owns and properties which the company rents. Under the ED, properties and commercial premises which today are rented through what are known as operating leases appear on the lessee's balance sheet. This has the result that the company may have to account for those properties/premises which the company at present rents. These properties/premises may be classified as a tangible asset such as Properties. These properties/premises may alternatively be classified as right to use under intangible assets such as Renting Rights.

A conceivable treatment of properties/premises in capital adequacy assuming that the ED becomes a new IFRS standard

The way in which the company classifies named rights to use may be of crucial significance in capital adequacy.

In addition to the company placing properties/premises on the balance sheet in the capacity of lessee, capital adequacy also has to be calculated for these properties/premises. If they are classified as tangible assets in the form of Properties, under Chapter 15 Section 1, Section 3 and Section 4(15) and Chapter 16 Section 45 of the Swedish Financial Supervisory Authority Regulations and General Guidelines regarding Capital Adequacy and Large Exposures (FFFS 2007:1), these have to be

adequately capitalised. These rules signify eight per cent in capital requirement on the book value of properties/premises.

In the second case the contracts are classified as intangible assets in the form of Renting Rights. Under Chapter 3 Section 2 second paragraph second point of the Capital Adequacy and Large Exposures (2006:1371) Act, these have to be deducted in full from the company's original own funds (tier I capital). This rule means a 100 per cent capital requirement on the book value of the properties/premises. As the original own funds decreases, the basis for how much additional own funds (tier II capital) the company can have in its capital base also falls, as a result of the original own funds governing how much additional own funds the company has scope for. As significant sums ought to be concerned here, such an interpretation may have a substantial adverse impact on the capital adequacy situation of companies.

Deducting the book value of the properties/premises entirely from the original own funds does not in any way reflect the risk to which the company is exposed by renting the properties/premises mentioned. Renting properties/premises in reality represents a smaller risk than owning the corresponding asset. Treatment according to the present-day rules on capital adequacy therefore signifies a gross overestimate of the risk which the company has taken on. The operating leases (according to present-day rules) where the company is a lessee, for example with respect to cars, office equipment and IT, should be added to the issues mentioned above.

On the assumption that the ED becomes a new IFRS standard, the rules on capital adequacy should be reviewed as soon as possible with regard to the treatment of intangible and tangible assets. Responsibility for this review rests with the European Commission and the Basel Committee on Banking Supervision.