LEASES

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INTRODUCTION

1. Under the Memorandum of Understanding published in February 2006, the IASB and FASB have undertaken to consider and make a decision about the scope and timing of a potential project on leases by 2008.

2. At a joint meeting in April 2006, the Boards of the IASB and FASB held a preliminary discussion on whether to add a project on leases to their agendas. Both Boards were broadly supportive of the proposal and it was agreed that a joint project would be preferable.

3. The staff proposes to work towards a discussion paper to be issued jointly by the IASB and FASB, no earlier than 2007. Given the significance of the changes that are anticipated, staff are of the view that it is not appropriate to move directly to an exposure draft.

BACKGROUND

4. Leasing is a major international industry, and a very important source of finance for a wide range of entities. Total equipment leasing volume in 2004 is reported as US$ 579 billion, an increase of some 14% over the previous year. The US accounted for 42% of this, Europe 37% and Asia 14%.[1]

5. Lease accounting is important not only for the large number of equipment lessors (for example, the US Equipment Leasing Association (ELA) has over 850 members; the UK Finance & Leasing Association (FLA) over 100); a large

[1] Source: World Leasing Yearbook; excludes property leasing.

proportion of commercial and other property is held on a leased basis; and most business entities and public bodies are lessees in some form or other. Accordingly, accounting for leases affects entities across all categories.

6. The basis for the current model for lease accounting was originally established in FAS 13, issued in 1976, and followed by other standards (e.g. IAS 17 in 1982, UK's SSAP 21 in 1984). Under these standards, leases which are regarded as transferring substantially all the risks and rewards of ownership of the leased item are accounted for by recognising the leased item as an asset of the lessee, with a corresponding liability to the lessor for the lease rentals. However, leases that do not meet this test are accounted for only as rental obligations accrue. The lease accounting standards contain tests to determine whether a lease is regarded as transferring substantially all the risks and rewards of ownership (a finance lease or capital lease).

7. However, criticism of the current lease accounting model has increased over recent years. The SEC in its June 2005 Report under the Sarbanes-Oxley Act into off-balance-sheet arrangements noted:

> "The lease accounting standards rely extensively on bright lines, greatly increasing the potential for similar arrangements to be portrayed very differently. Indeed, for a lessee, the accounting can flip between recording no assets and liabilities at a lease inception to recording the entire leased asset and entire loan price with only a very small change in economics. As discussed previously, the bright line tests have served to facilitate significant structuring of leases to obtain particular financial reporting goals. The extensive structuring further erodes the effectiveness of the standards." (page 106)

AGENDA CRITERIA

8. In addition to considering the extent of any resource constraints, the due process handbook sets out four factors to be considered in deciding whether to add an item to the agenda:

- the relevance to users of the information involved and the reliability of information that could be provided;
- the existing guidance available;
- the possibility of increasing convergence; and
- the quality of standards to be developed.

9. These factors are considered further below:

The relevance to users of the information involved and the reliability of information that could be provided

10. The staff believe that the development of a lease accounting standard based on conceptually sound and consistent principles would result in the recognition of assets and liabilities that more accurately reflect the rights acquired and obligations assumed in a leasing transaction.

11. The current standard results in the omission from the balance sheet of substantial leasing obligations that appear to meet the definition of liabilities; users routinely adjust liability and gearing ratios, to reflect these omitted liabilities.

12. Similarly, rights to economic benefit that appear to meet the definition of an asset are not recognised under the current standard leading to distortion of asset based ratios.

13. The bright line distinction between operating and finance leases in current lease accounting standards can result in very different accounting for transactions that are economically very similar; and is seen as encouraging the structuring of transactions to achieve a preferred accounting treatment.

14. Given the size of the leasing industry and the importance of leasing as a source of finance to a wide range of entities, the improved relevance and reliability of reporting of leasing transactions that would result would be a major improvement in financial reporting.

Existing guidance available

15. Although there are existing lease accounting standards, these standards are regarded as out of date, unnecessarily complex and result in reporting that does not properly represent leasing transactions.

16. The main concerns with the current lease accounting model are set out below.

(a) The dividing line between finance leases and operating leases leads to transactions being structured so that they fall just to the operating lease side of the dividing line, thus providing what might be regarded as off-balance-sheet financing.

(b) The bright-line distinction between operating leases and finance leases inevitably leads to very different assets and liabilities being recognised for transactions which are economically very similar.

(c) A non-cancellable lease gives rise to obligations of the lessee that are often regarded as little different from borrowings, but which in the case of operating leases are not recognised as liabilities. Similarly, assets held under operating leases are not recognised on the balance sheet. As a result, analysts and other users of financial statements make estimated adjustments to reflect these assets and obligations in their analysis.

(d) There are significant and growing differences between the lease accounting and other standards.

(e) Finally, lessor accounting is based on concepts of deferral and matching that are very different from the asset/liability measurement approaches to revenue recognition that underpin the Board's developing standards.

Possibility of increasing convergence

17. As noted above, existing lease accounting standards are generally based on the principles developed for the US standard FAS 13. Consequently, the same basic model for lease accounting underpins the standards in most major jurisdictions. However, there are many differences in detail that lead to different accounting outcomes. Given the significance of the leasing industry and lease finance, these

apparently minor differences can give rise to very substantial differences in financial statements.

18. The staff believe that a lease accounting standard jointly developed with the FASB would significantly contribute towards international convergence.

Quality of standards to be developed

19. Considerable work has already been undertaken by the G4 + 1 and in the joint project with the ASB to develop a conceptually sound approach to lease accounting. The staff believe that this work has shown that it is possible to develop a comprehensive lease accounting standard within a reasonable timeframe.

20. The proposed project would analyse the rights acquired and obligations assumed in leasing transactions and result in the recognition of assets and liabilities that more closely reflect these rights and obligations leading to an improvement in the relevance and reliability of financial statements. This, together with the removal of the arbitrary distinction between finance and operating leases, would enhance the understandability and comparability of those statements.

21. It is important that the Boards can show that they have balanced the costs and benefits of the new model that is being developed. The benefits will largely be in terms of improved financial reporting, and in financial statements that more clearly reflect the true nature of the transactions entered into. In addition, there are currently inconsistencies between the accounting for items that qualify as leases and other similar transactions that do not. Reduction of such inconsistencies will represent a major improvement in the quality of reporting.

22. The staff believe that the benefits of improved financial reporting will outweigh any costs associated with a new standard (for example systems costs) but this aspect will be monitored as the project progresses.