



Finance and Leasing Association

Exposure Draft ED/2010/9 Leases

Comment letter

1. The Finance & Leasing Association (FLA) is the UK's leading trade association for the consumer, motor and asset finance sectors. Our members are banks, subsidiaries of banks and building societies, the finance arms of leading retailers and manufacturing companies and a range of independent firms. In a typical year, our members fund £25 to £30 billion of new business assets through leasing and hire purchase arrangements. Our members have £66 billion in outstanding business loans with 750,000 UK businesses.
2. As a member of Leaseurope our detailed views on the conceptual and technical aspects of the Exposure Draft (ED) are reflected in the Leaseurope comment letter. Examples of conceptual and technical concerns, shown in detail in the Leaseurope comment letter, include:
 - The Boards' analysis of lessee and lessor rights and obligations is inconsistent (*Question 1a*)
 - The proposals for subsequent measurement would make it difficult to compare lessees' accounts (*1b*)
 - There is no logic for having multiple reporting models for lessors when there is only one model for lessees (*2a*)
 - The performance obligation model has no persuasive conceptual grounding and does not accurately represent the economics of a lease transaction (*2b*)
 - The definition of a lease is too broad and would create confusion by leading to many contracts that are today considered to be services being accounted for as leases (*4a, 4c*) and many contracts that are today considered to be leases to be accounted for as sales (*4b*)
 - There would be no guidance available on how to account for leases of intangible assets such as software (*5*)
 - Taking account of options on the basis of the 'longest possible lease term that is more likely than not to occur' would result in lessees recognising assets and liabilities that they do not have and is inconsistent with the Conceptual Framework (*8*)
 - The proposed approach to accounting for contingent rentals and expected payments under residual value guarantees implies that lessees would recognise obligations they have the discretion to avoid and lessors assets they do not control (*9*)
 - Under the proposed transitional arrangements, lessees would misleadingly have to recognise significant losses on existing leases (*16a*) and would effectively be recognising depreciation that they have already accounted for (*16c*).

3. Our comments below are in response to Question 17: *Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?*
4. We believe that the benefits of the proposals as they stand are very unlikely to outweigh the costs. However we suggest that the Boards could meet their objectives for this project by setting less costly requirements.

Use of operating leases

5. In considering the costs and benefits of the proposals it is important to have up-to-date information on the use of leasing by UK companies. To provide this we asked Professor Neil Marriot and Dr. Pru Marriot of Winchester Business School at the University of Winchester to analyse the size of operating leasing by companies on the main UK Stock Exchange. Their report is attached as Annex B.
6. The UK is probably the only major market where many companies report their operating leases split between property and 'other' in the notes to the accounts. This is a legacy of the old UK reporting standard that required such a breakdown. Although not all companies still report their operating leases in this way, by inferring information from sector averages of companies that had reported the two categories, the researchers were able to complete a dataset of 225 companies from across the Stock Exchange.
7. For this sample of 225 quoted companies of all sizes, excluding a particular group of ten companies, total operating lease commitments at 2009 year-ends were on average £463 million. On average, this was split £445 million (96%) per company for property and £18 million (4%) per company for all other leases. This suggests there is likely to be limited benefit to users of the accounts of almost all UK companies of putting non-property operating leases on the balance sheet. It also confirms that there is minimal, if any, 'structuring' of non-property leases in the UK.
8. The research identified ten companies, all within the transportation and communications sectors, where there was much higher use of non-property operating leases. These were British Airways, British Telecom, Cable and Wireless, TUI, Vodafone, Arriva, easyJet, First group, Stagecoach, and Go Ahead. These ten companies had total estimated property operating lease commitments of £3 billion and total 'other' lease commitments of £25 billion. Many of these companies also had large finance leases.
9. Based on this research, the proposed requirements appear to be poorly targeted. There is a strong case for keeping the requirements simple for most equipment leases at most companies.

Practical effects of the proposals for preparers

10. The costs to preparers of the proposals could be very substantial. To help estimate the costs it is necessary first to list the work that would be needed to prepare accounts using the proposed rules. We estimate there are around 75 such steps, compared to around 10 for an operating lease and 30 for a finance lease under IAS 17. An illustrative list of the steps, based on our current understanding of the proposals, is shown in Annex A.
11. Around half of the steps involved should be fairly quick for an accountant to carry out once he/she has worked through a few cases. Some of the steps towards the beginning of the list, for example, are quick checks to confirm that the agreement is a lease for reporting purposes. For example assessing whether the fulfillment of the contract depends on providing a specified asset or assets (*paragraph B2 of the Application guidance*) should be a simple matter of checking the lease paperwork.
12. The challenge with these 'tick-box' steps would be ensuring a robust process was followed so that the steps were always carried out and suitable evidence recorded. We doubt that the process could be automated and lessors could not greatly reduce the burdens for their customers.
13. Other steps would involve collecting information or using expertise that is unlikely to be 'on hand' within a company's accounting function. For example establishing whether at the end of a contract the lessor would transfer to the lessee control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset (*paragraph B9 of the Application guidance*) would require comparison of the expected actual output and the theoretical capacity of the asset. That assessment would need to come from someone with a reasonable degree of expertise in the type of equipment being used who was also familiar with the company's expected use of the equipment.
14. Few of these assessments could be simplified or automated. It has been suggested that the appropriate treatment for a fleet of leased cars could be based on a 'sample' car or 'sample' group of cars. Unfortunately this is unlikely to be practical. The assessments needed are likely to vary for different offices, groups of users or types of vehicles. There would therefore be substantial new data collection requirements to support the necessary assessments by the lessees.
15. We estimate that every lease agreement would require between half a day and two days of accounting staff time per year. Large companies could have hundreds of agreements so could require at least one extra member of staff in their accounting departments. Other costs would include:
 - Fees for external advisers such as asset specialists
 - The time of operational managers needed to provide information on the actual and expected use of equipment

- IT systems changes including new or enhanced asset registers
- Legal costs and management time for changing debt covenants
- Investor relations expense in explaining the impact of the changes
- Costs of maintaining extra accounting records for tax purposes which HM Revenue and Customs have estimated at costing £100 million across the economy in one-off costs and then £50 million average annual costs¹
- Higher audit fees.

Effects of the proposals for users

16. Although there are potential benefits to users of having all the information on leases in the same place in the accounts, there are also potentially significant costs for users. Many users are investors in companies or their advisors. Any new regulatory burdens, as described above, would affect the value of their investment.
17. The new disclosures would also actually have the effect of complicating financial reports rather than simplifying them. Notes to the accounts will become much longer, making annual reports even thicker than they are already. This comes soon after the Financial Reporting Council (FRC) reported that “Complexity in corporate reporting is a multi-faceted problem that will require changes in behaviour from all members of the corporate reporting community”². The FRC called for regulators to intervene only when an area is high-risk and change would bring obvious benefit.
18. The root cause of the complexity in the ED appears to be a concern that preparers might deliberately structure lease transactions to circumnavigate simpler rules. However we have seen from the Winchester Business School research findings that there is limited, if any, evidence of such structuring in the UK today. As the Institute of Chartered Accountants in England and Wales (ICAEW) noted last year, “most people who prepare business reporting information are honest and conscientious and take pride in their work. They do not set out to mislead, but to convey an accurate picture of what the information is intended to represent.”³

Indirect effects of the proposals

19. Any regulatory change of this size is bound to have substantial indirect effects. The IASB should allow time for them to be fully worked through so as to minimise any unintended consequences.

¹ Changes to Accounting Standard for Leases, HM Revenue and Customs, 9 December 2010

² Louder than Words: Principles and actions for making corporate reports less complex and more relevant, Financial Reporting Council, 2009

³ Developments in New Reporting Models, The Institute of Chartered Accountants in England and Wales, 2009

20. Changes to lease accounting rules would have a significant impact on the UK tax system, requiring legislative change and major redesign. This takes years, not months. The proposed 'stopgap' measure would involve lessees having to maintain two sets of accounts, one for financial reporting; the other for use in tax calculations. As noted above, HM Revenue and Customs has estimated the cost of this at £100 million initially then £50 million per year.
21. For banks there could be substantial effects on their ability to lend to businesses because of the capital that may be required in relation to the "right of use" asset. It should be possible to avoid such impacts by adjusting the capital requirements rules. However the Financial Services Authority or its successor body would need time to consider, consult on, and implement any such changes.
22. There would also be major implications for public authorities. IAS 17 has only very recently been implemented in the UK public sector. Changing the rules again would require HM Treasury to reassess leases and implement procurement policy changes that could cause considerable disruption across the public sector.

Small companies

23. An assessment of costs and benefits should consider the eventual impact of the changes on all companies in the UK, not only existing IFRS users. The Accounting Standards Board (ASB) plans to adopt IFRS for SMEs for Medium-sized companies in the UK through the planned Financial Reporting Standard for Medium-Sized Entities (FRSME). The existing Financial Reporting Standard for Smaller Entities (FRSEE) generally mirrors the relevant standards that apply to larger companies.
24. The IASB and the ASB might adjust the new standard before disseminating it to medium and small companies through FRSME and FRSEE. But they would still be starting with a standard designed for larger companies. This would be contrary to the 'Think Small First' principle of good regulation. Starting with more straightforward rules for existing IFRS users would help ensure that the new rules can be extended to smaller companies in due course.

Conclusions

25. The costs associated with the proposals outweigh the benefits. The proposals are poorly targeted and would impose severe new regulatory burdens on most UK companies. They are complex for preparers, adding extra administrative and other costs of at least £100,000 per year for many companies, just for their equipment leases. They would make financial reports longer and more complex. They could have very serious unintended consequences if implemented without at least two clear years for preparation.

26. Fortunately it is possible to improve the proposals whilst still meeting the Boards' objectives. Leaseurope has prepared an alternative right of use model that would reduce the cost to preparers and make the reported assets and liabilities easier to interpret and predict.

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Annex A: Steps to accounting for a lease under the International Accounting Standards Board's proposals – ILLUSTRATIVE

Step	What to do	Information needed	Guidance
1.	Check whether an asset is identified in the contract and how it is described	The lease agreement and accompanying paperwork	B1 (a)
2.	Work out whether the leasing company can change the equipment that you are renting	The lease agreement and accompanying paperwork	B1 (a)
3.	Find out whether the lessor has a pool of assets, any one of which could be used to fulfill the contract	Advice from lessor	B2
4.	Work out whether it is actually practical for the leasing company to change the equipment that you are renting	Details of any modifications made to the equipment to suit your requirements during the rental period An assessment from someone with a reasonable degree of expertise in the type of equipment being rented	B2
5.	Work out whether the leasing company can only change the equipment when it is not working properly	The lease agreement and accompanying paperwork	B3
6.	Work out whether the leasing company can change the equipment now, rather than only after a certain date in the future	The lease agreement and accompanying paperwork	B3
7.	Work out whether there are any restrictions on using the equipment	The lease agreement and accompanying paperwork	B4 (a)
8.	Work out whether anyone else will use the equipment for a significant part of the output / utility	Details of the expected actual output and theoretical capacity of the asset An assessment from someone with a reasonable degree of expertise in the type of equipment being rented	B4 (a and c)
9.	Work out whether you can stop other people using the equipment if you want to	The lease agreement and accompanying paperwork	B4 (b)
10.	Check if the amount you pay is fixed by the contract	The lease agreement and accompanying paperwork	B4 (c)
11.	Check whether the amount that you pay depends on the use you make of the equipment	The lease agreement and accompanying paperwork	B4 (c)

Step	What to do	Information needed	Guidance
12.	Check the lease is for an asset in an excluded category	The lease agreement and accompanying paperwork	5
13.	Check whether you will automatically own the equipment by the end of the lease	The lease agreement and accompanying paperwork	8 (a)
14.	Check if you expect to receive all but a trivial amount of the risks and benefits associated with the leased asset	Details of the expected actual output and theoretical capacity of the asset An assessment from someone with a reasonable degree of expertise in the type of equipment being rented	B9
15.	Check if there is a bargain purchase option	Expected market prices of asset	B10
16.	Taking into account all of the above, assess whether the contract is in-scope	Above	9
17.	Consider whether this is a short-term lease. If so, decide whether you want to use the alternative treatment for short term leases or the full standard	The lease agreement and accompanying paperwork	64
18.	Check the minimum rental period	The lease agreement and accompanying paperwork	B18 (a)
19.	Check how much you would have to pay after the minimum rental period	The lease agreement and accompanying paperwork	B18 (a)
20.	Check the rules for returning the equipment	The lease agreement and accompanying paperwork	B18 (a)
21.	Check whether there are any special charges for returning the equipment at different times	The lease agreement and accompanying paperwork	B18 (a)
22.	Check what there are any legal considerations that could affect the possible lease terms	Legal advice	B18 (a)
23.	Check whether there are any regulations that could affect the cost of returning the equipment at different times	An assessment from someone with a reasonable degree of expertise in relevant regulation	B18 (b)
24.	Check whether there are any tax consequences of returning the equipment at different times	An assessment from someone with a reasonable degree of expertise in tax rules	B18 (b)

Step	What to do	Information needed	Guidance
25.	Check whether there are any operational consequences of returning the equipment at different times, e.g. costs of lost production	An assessment from someone with a reasonable degree of expertise in the business operations	B18 (b)
26.	Check other business reasons for keeping or returning the equipment, such as whether the equipment is particularly specialised and so difficult to replace, or in a location where it is difficult or expensive to replace or return to lessor	An assessment from someone with a reasonable degree of expertise in the business operations	B18 (c)
27.	Check the intentions of managers in the area of the business using the equipment	Views of relevant managers	B18 (c)
28.	Check the businesses' past practice in keeping or returning similar rented equipment	Company records, discussions with relevant managers	B18 (d)
29.	Check whether there are any pre-defined options for extending the lease or whether you would have the right to continue to use the asset after the end of the contract	The lease agreement and accompanying paperwork	B19
30.	Check any requirement to pay the leasing company extra money if the value of the equipment is lower than a certain amount at the end of the lease	The lease agreement and accompanying paperwork Views of equipment valuation expert	B19
31.	Taking into account all of the factors above, identify each reasonably possible lease period that could occur	Above information	B21 (a)
32.	Determine the probabilities associated with each possible lease period	Above information	
33.	Determine the longest possible lease term that is more likely than not to occur	Above information	
34.	Estimate the amount and timing of the cash flows for each reasonably possible outcome	The lease agreement and accompanying paperwork	B21 (b)
35.	Check if lease payments include any charges for services that are 'distinct'	Assessment of the lease agreement together with information from lessor on whether an identical or similar service is sold separately	B6, B7
36.	If information on amount of service component is not available, compare contract with equivalent lease without services or service-only contracts to make estimate of service amount	Expert on leasing market	
37.	Deduct from the lease payments any charges for services, if possible	The lease agreement and accompanying paperwork.	6, B5
38.	Calculate initial direct costs, including commissions, legal fees, preparing and processing lease documents, etc	Managers involved in arranging the lease.	B14-15

Step	What to do	Information needed	Guidance
39.	Add initial direct costs to lease payments	Calculation	12 (b)
40.	Work out the relevant discount rate	Quotes from banks for equivalent types of financing, or information from lessor on rate used in pricing.	12 (a) B11-13
41.	Identify whether the contract contains contingent rental payments	The lease agreement and accompanying paperwork	14 (a)
42.	Are there payments linked to a rate or index? If so, obtain forward rates or indices	Forward rates or indices	14 (a)
43.	Are there payments linked to the usage of the asset? If so, determine what usage of the asset would be under different scenarios	Plans from operational managers of likely use of equipment. Budgets and other forecasts.	14 (a)
44.	Are there payments linked to performance (e.g. turnover)? If so, determine what your turnover would be under different scenarios	Plans from operational managers of likely use of equipment. Budgets and other forecasts.	14 (a)
45.	Make an estimate of any contingent rentals payable under these scenarios	Above information	14(a)
46.	Assign a probability to each of these scenarios	Above information	14(a)
47.	Make an estimate of any amounts payable under residual value guarantees under various scenarios. Assign a probability to each scenario	Advice from expert in the type of equipment	14 (b)
48.	Make an estimate of expected payments under term option penalties under various scenarios. Assign a probability to each scenario. Calculate expected payment using a probability weighted outcome technique	Plans from operational managers of likely use of equipment	14 (c)
49.	Calculate the present value of each of the expected payment (except for relevant short-term leases)	Calculation	14, B21
50.	Measure the interest expense on the liability to make lease payments using the effective interest method	As above	11 (a)
51.	Determine the useful life of the underlying asset. Compare this to the lease term established above and select the shorter period as the amortization period	Advice from expert in the type of equipment	20
52.	Select the amortisation method on the basis of the expected pattern of consumption of the future economic benefits embodied in the right of use asset	Advice from expert in the type of equipment	20
53.	Test for any indication of impairment at each reporting date	Market values, condition reports	24
54.	Determine the recoverable amount of the asset (i.e. the higher of its fair value less costs to sell or its value in use)	Whether there have been significant changes affecting your business or the market to which the right of use asset is dedicated	
55.	If the recoverable amount of the asset is less than its carrying value, recognise an impairment loss	Information on the future cash flows you expect to derive from the asset	24
56.	Reassess the lease term, contingent rentals and expected payments under term option penalties at each reporting date	Updated information as collected in steps above	17, B20

Step	What to do	Information needed	Guidance
57.	Revalue the right-of-use asset (optional) if you revalue all equivalent owned assets in the property class and recognise gains and losses	Evidence of fair value of asset	17, B20
58.	Perform revaluations regularly	Paperwork from leasing company, equipment reports e.g. damages.	21
59.	Recognise differed tax assets/liabilities for book/tax timing differences that will arise	As above	
60.	Review the amortization period and method at least once a year	As above	20
61.	Accounts preparation <ul style="list-style-type: none"> • Carry out book entries at time of delivery (e.g. book initial payment obligation as liability, book right of use as asset) • Carry out book entries for monthly invoices (e.g. book the rent / decrease payment obligation) • Carry out book entries for monthly closing (to be repeated over contract life) (e.g. Book amortization of right of use, book interest on payment obligation, book depreciation if necessary) • Carry out book entries for any contract adjustments • Carry out book entries for monthly closing (e.g. book rent to payment obligation) • Carry out book entries for end of contract (e.g. book additional mileage invoice, book refurbishment invoice) 	As above, plus invoices and other communications from lessor	25-27
62.	Provide a general description of lease arrangements	Catalogue of lease agreements	73 (a) (i)
63.	Provide the basis and terms on which contingent rentals are determined	Details of lease agreements	73 (a) (ii)
64.	Provide details of options for renewal and termination	Details of lease agreements	73 (a) (iii)
65.	Provide details of options for purchase of the underlying asset	Details of lease agreements	73 (a) (iv)
66.	Provide information about assumptions and judgments relating to amortization methods	Details of lease agreements	73 (a) (v)
67.	Provide information on the existence and terms of residual value guarantees	Details of lease agreements	73 (a) (vi)
68.	Provide information on initial direct costs	Details of lease agreements	73 (a) (vii)
69.	Provide information on restrictions imposed by lease agreements	Details of lease agreements	73 (a) (viii)
70.	Provide information on future leases	Details of lease agreements	73 (b)
71.	Provide information on significant subleases	Details of lease agreements	74
72.	Provide information on short-term leases	Details of lease agreements	75
73.	Provide information on sale and leaseback transactions	Details of lease agreements	76
74.	Provide a reconciliation of opening and closing values for right of use assets and lease liabilities, disaggregated by underlying asset class. Show the cash payments separately	Above information	77
75.	Maintain records of all leased equipment	Operating system to monitor usage, location, maintenance, damage etc by individual asset	

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The University of Winchester

Winchester Business School

Lease Accounting Research for the Finance and Leasing Association (FLA)

**The potential impact of the “right-of-use model” for lease accounting
on a sample of UK companies**

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FLA Research Study - Winchester Business School

The University of Winchester

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Lease Accounting Research for Finance and Leasing Association

**The potential impact of the “right-of-use model” for lease accounting
on a sample of UK companies**

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Introduction

The accounting model for leases, while the subject of criticism, has not changed for many years. The current rules which determine the classification of leases can result in similar transactions being reported in different ways leading to a lack of comparability and significant amounts of off-balance sheet finance not being recognised. The Financial Accounting Standards Board and the International Accounting Standards Board released an exposure draft in August 2010, and plan to release a standard in 2011, with the aim of establishing a single conceptual model for the recognition and measurement of all lease contracts. Currently, there are different accounting rules applied to finance leases and operating leases, with the latter considered off balance sheet. However, the new rules would change this accounting treatment and those businesses with operating lease commitments will see their assets and liabilities increase significantly.

The accounting model being considered would affect nearly every company in the UK, with the greatest impact evident on lessees of large value assets such as property, transport, communications and manufacturing equipment. These changes could impact lessors' businesses because some lessees may decide to buy rather than lease if operating leases are eliminated under the "right-of-use model". The proposals would impact gearing and other ratios and the timing of income statement recognition.

In order to respond to the exposure draft the FLA requires an analysis of the size of operating leasing by companies of various sizes in the UK and to estimate the changes to companies' accounts arising from the proposed new accounting standard. This requires a range of estimates derived from an analysis of the notes contained within the annual reports of companies. This report outlines the method used to gather a large sample of data and the results analysed over a range of sectors.

Method

A sample comprising of 97 of the FTSE100, 99 of the FTSE350 and 98 of the FTSE All Share listed companies was extracted from data available in the annual reports for the year ending 2009. The sample is not intended to be random, but designed to capture an indication of the potential impact of the proposed accounting change across a range of companies, including some of the largest in the UK. Nearly all the top companies are included and a representative sample of FTSE350 and FTSE All Share companies are considered.

Obtaining the data for this research was a time consuming task involving scrutiny of the annual reports of the companies selected, searching for information relating to operating lease commitments (OLC) where there were any and using the information available to make reasonable inferences for companies operating in the same industrial sector for other variables where exact data was not provided. Table 1 indicates where actual data was available, where details of the split between property and non-property OLC were not available and where it was possible to infer data from the information that was provided.

The sampling method, the inference techniques and subsequent analysis are not an attempt to suggest a study with external validity, but a high degree of internal validity is achieved as explained below.

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Table 1 Sample Description

SIC Main Section Headings	N	OLC Split Available	OLC Split Not Available	OLC None	OLC Inferred Split	OLC Usable
Agriculture, hunting and forestry	2	2	0	0	0	2
Mining and quarrying	27	10	14	3	0	10
Manufacturing	76	47	26	2	25	72
Electricity, gas and water supply	9	3	6	0	0	3
Construction	13	6	6	1	0	6
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	26	19	7	0	7	26
Hotels and restaurants	8	4	3	1	3	7
Transport, storage and communication	13	9	1	3	1	10
Financial intermediation	44	21	11	12	11	32
Real estate, renting and business activities	54	28	15	11	15	43
Health and social work	2	0	2	0	0	0
Other community, social and personal service activities	10	4	5	1	0	4
Outliers – Transport, storage and communication	10	7	3	0	3	10
	294	160	99	34	65	225

Of the 294 companies in the sample 160 (54%) companies provided data for operating lease commitments (OLC) divided between property and non-property.

By inferring information from sector averages, it was possible to produce a further set of data for operating lease commitments (n=65) making a usable data set of n= 225 (77%). It was not possible to make inferences for the remaining 69 companies due the absence of some or all of the information relating to operating leases. This applied mainly to sectors that were too small to analyse with any degree of reliability and to companies that were deemed to be outliers and that would bias significantly the results. There were some companies in the sample that did not provide any information on OLRs and OLCs, i.e. did not have any operating leases. These were also excluded from initial analysis as to include them would reduce the impact on companies with lease commitments that had no split of data which the analysis was attempting to infer.

The outliers are within the Transport, Storage and Communications sector and include the following companies with large non-property OLCs:

FTSE 100 Companies – British Airways, British Telecom, Cables and Wireless, TUI, Vodaphone

FTSE 350 Companies – Arriva, Easy Jet, First Group, Stagecoach

FTSE All-Share Companies – Go Ahead

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The initial method adopted for inference was based on the calculation of a factor derived from the available data for OLRs and OLCs. However, this produced information contrary to the limited data that was available in the financial statements, e.g. the total OLR may have been available, but not the Property/Non-Property split. Applying the factor to OLR data to infer an amount for OLC resulted in variables that were grossly different to the information available in the Income Statement. This produced results that were incredulous and intuitively incorrect.

An alternative methodology was deployed and used all the information that was available. Sector averages were calculated and, using the percentage split of these averages, the missing data was inferred. This was deemed more accurate and the revised data set was reanalysed using the known and inferred data. After including the inferred data, the averages are within 2% of the actual data, providing a degree of confidence in the methodology.

Analysis

The analysis indicates that the effect of the IFRS standard would be to increase company total assets and total liabilities by an average of approximately £463 million per company in the sample (equal to total operating lease commitments) with £445m per company relating to property and £18m per company for non-property. This average does not include the outliers which have been analysed separately (see Table 2).

The sample of 294 companies included 260 companies (88%) that disclosed total operating lease commitments in their financial statements which amounted to £153,476m but not all of this could be split between property and non-property.

The results are provided in the following tables.

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Table 2 Operating Lease Commitments

		Property	Non-Property	Total
Usable sample excluding outliers	n=215			
	Total £m	95594	3964	99558
	Average £m	445	18	463
	Percentage	96%	4%	100%
FTSE 100				
	n=64			
	Total £m	71190	2533	73723
	Average £m	1112	40	1152
	Percentage	97%	3%	100%
FTSE 350				
	n=75			
	Total £m	14554	838	15372
	Average £m	194	11	205
	Percentage	95%	5%	100%
FTSE All Share				
	n=76			
	Total £m	9850	597	10447
	Average £m	130	8	138
	Percentage	94%	6%	100%
Outliers				
	n=10			
Transport	Total £m	2715	25497	28212
	Average £m	272	2550	2822
	Percentage	10%	90%	100%

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Table 3 Agriculture, Hunting and Forestry Sector

	Operating Lease Commitments		
	Actual n=2	Inferred n=0	Actual + Inferred n=2
(Total n = 2)			
Property			
Average £ millions	9	0	9
Percentage	100%	0%	100%
Non-Property			
Average £ millions	8	0	8
Percentage	100%	0%	100%
Total			
Average £ millions	17	0	17
Percentage	100%	100%	100%

Table 4 Mining and Quarrying

	Operating Lease Commitments		
	Actual n=2	Inferred n=0	Actual + Inferred n=2
(Total n = 10)			
Property			
Average £ millions	43	0	43
Percentage	100%	0%	100%
Non-Property			
Average £ millions	63	0	63
Percentage	100%	0%	100%
Total			
Average £ millions	106	0	106
Percentage	100%	100%	100%

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Table 5 Manufacturing Sector

	Operating Lease Commitments		
	Actual n=47	Inferred n=25	Actual + Inferred n=72
(Total n = 72)			
Property			
Average £ millions	148	147	148
Percentage	87%	87%	87%
Non-Property			
Average £ millions	22	22	22
Percentage	13%	13%	13%
Total			
Average £ millions	170	169	170
Percentage	100%	100%	100%

Even though there are a relatively large number of inferred data using the sector average, the percentages remain unaltered. The Manufacturing Sector makes quite high use of leased equipment, but the main leased asset is property.

Table 6 Electricity, Gas and Water Supply Sector

	Operating Lease Commitments		
	Actual n=3	Inferred n=0	Actual + Inferred n=2
(Total n = 3)			
Property			
Average £ millions	84	0	84
Percentage	100%	0%	100%
Non-Property			
Average £ millions	1	0	1
Percentage	100%	0%	100%
Total			
Average £ millions	85	0	85
Percentage	100%	0%	100%

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Table 7 Construction

	Operating Lease Commitments		
	Actual n=6	Inferred n=0	Actual + Inferred n=6
(Total n = 6)			
Property			
Average £ millions	23	0	23
Percentage	67%	0%	67%
Non-Property			
Average £ millions	11	0	11
Percentage	33%	0%	33%
Total			
Average £ millions	34	0	34
Percentage	100%	0%	100%

Table 8 Wholesale and Retail Sector

	Operating Lease Commitments		
	Actual n=17	Inferred n=9	Actual + Inferred n=26
(Total n = 26)			
Property			
Average £ millions	1272	3080	1759
Percentage	99%	99%	99%
Non-Property			
Average £ millions	16	31	20
Percentage	1%	1%	1%
Total			
Average £ millions	1288	3111	1779
Percentage	100%	100%	100%

*FLA Research Study - Winchester Business School***Table 9 Hotels and Restaurants Sector**

	Operating Lease Commitments		
	Actual n=4	Inferred n=4	Actual + Inferred n=7
(Total n = 7)			
Property			
Average £ millions	682	186	486
Percentage	91%	91%	91%
Non-Property			
Average £ millions	66	18	47
Percentage	9%	9%	9%
Total			
Average £ millions	748	204	533
Percentage	100%	100%	100%

Table 10 Transport, Storage and Communications Sector

	Operating Lease Commitments		
	Actual n=9	Inferred n=1	Actual + Inferred n=10
(Total n = 10)			
Property			
Average £ millions	135	3	122
Percentage	76%	14%	75%
Non-Property			
Average £ millions	44	18	41
Percentage	24%	86%	25%
Total			
Average £ millions	179	21	163
Percentage	100%	100%	100%

The Transport, Storage and Communications Sector posed most problems in the analysis and this is where there were significant outliers, see above. Even after removing these outliers from this table, this sector makes significant use of non-property leases, far more than any other sector.

*FLA Research Study - Winchester Business School***Table 11 Financial Intermediaries Sector**

	Operating Lease Commitments		
	Actual n=21	Inferred n=11	Actual + Inferred n=32
(Total n = 32)			
Property			
Average £ millions	693	792	727
Percentage	99%	97%	97%
Non-Property			
Average £ millions	3	8	5
Percentage	1%	3%	3%
Total			
Average £ millions	696	800	732
Percentage	100%	100%	100%

Table 12 Real Estate and Property Sector

	Operating Lease Commitments		
	Actual n=28	Inferred n=15	Actual + Inferred n=43
(Total n = 43)			
Property			
Average £ millions	267	142	223
Percentage	98%	98%	98%
Non-Property			
Average £ millions	6	3	5
Percentage	2%	2%	2%
Total			
Average £ millions	273	145	228
Percentage	100%	100%	100%

There was no data available for the Health and Social Work sector.

*FLA Research Study - Winchester Business School***Table 13 Other Community, Social and Personal Service Activities Sector**

	Operating Lease Commitments		
	Actual n=4	Inferred n=0	Actual + Inferred n=4
(Total n = 4)			
Property			
Average £ millions	231	0	231
Percentage	98%	0%	98%
Non-Property			
Average £ millions	6	0	6
Percentage	2%	0%	2%
Total			
Average £ millions	237	0	237
Percentage	100%	100%	100%

Table 14 Outliers - Transport, Storage and Communications Sector

	Operating Lease Commitments		
	Actual n=7	Inferred n=3	Actual + Inferred n=10
(Total n = 10)			
Property			
Average £ millions	175	377	203
Percentage	7%	7%	7%
Non-Property			
Average £ millions	2221	5004	2618
Percentage	93%	93%	93%
Total			
Average £ millions	2396	5381	2821
Percentage	100%	100%	100%

The outliers in the Transport, Storage and Communications Sector were different to other companies in that sector and to other companies in other sectors. However, they displayed similar characteristics to one another with a mirror image of the other companies in this analysis with 93% of the assets that were leased classified as non-property. Not only do these companies display a different pattern of leasing, they also lease nearly twice the average amount of assets than the next highest sector (Wholesale and Retail).

It is worth noting some of the characteristics of the transport companies (e.g. train companies such as Arriva, First Group, Stagecoach and Go Ahead) in this sample of outliers that have OLCs relating to access to the national rail network, stations and track. These rail network and station access charges typically amounted to more than half the OLCs. While these assets are not strictly defined as property, they display some of the characteristics of assets normally associated with property and not with plant and equipment. This was neatly expressed in Stagecoach annual accounts: “a

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significant part of the cost base is comprised of payments to the infrastructure provider, Network Rail, ... which are committed and do not vary with revenue.”

Another substantial category of non-property OLCs are leased lines in the telecoms sector. It is interesting to note that these leased non current assets share a ‘network’ characteristic with the leased assets of the train companies. These are further examples of assets that display some of the characteristics normally associated with property i.e. substantial expenditure tied to very long term asset infrastructure.

Conclusion

The impact on the annual reports of companies of the proposed change in accounting for leases may have an appealing theoretical basis and may be technically robust, but the behavioural implications may be far reaching. The actual impact will depend on variables that it has not been possible to estimate from the available data sources such as the NPV effect on the OLC which will make it lower and the impact of options to extend leases which may make it higher. These impacts may cancel each other out.

Given that most OLC are for property, the likelihood of companies now considering the purchase rather than the leasing of non-current assets could be quite significant. It is for other commentators from the industry to estimate the possible full effects from the data available in this short report.

Purchase decisions will not rest solely on the proposed accounting change and will be dependent on a range of factors such as the prevailing interest rate and the availability of internal or external finance. However, it is clear that the proposed new accounting standard will have a behavioural impact on the leasing industry in Britain and is not merely a book keeping exercise.

The potential impact on the banking sector has been commented upon in media reports, with the impact on their ability to lend adversely affected. This study indicates that there could be serious repercussions for other sectors of the UK economy including our major transport providers and manufacturing industry.

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Appendix – an explanation of the “Right of Use” model

IAS 17 and US GAAP require the lessee to recognise an asset and associated liability where the lease is a finance lease. The proposed standard requires the lessee to charge lease payments against profit where the lease is classified as an operating lease.

The classification as a finance or operating lease is dependent upon whether the risks and rewards of the asset’s ownership have passed to the lessee (finance lease) or remains with the lessor (operating lease). These accounting rules have been criticised by IASB because they do not follow their definitions of an asset and liability:

- An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

In revising the standards on leasing, the IASB and FASB have recognised that all leases, regardless of whether the risks and rewards of ownership have been passed to the lessee or not, will give rise to an asset (a right to use the asset) and a liability (obligations to pay lease rentals for the right to use the asset). The IASB’s Exposure Draft requires lessees and lessors to use a ‘right-of-use’ model in accounting for all leases. A lessee will have to recognise an asset and an associated liability, regardless of whether (or not) the lease may previously have been recognised as an operating lease. The impact of the proposed new leasing standard on the financial statements would be less in respect of current leases which are treated as finance leases. However, entities who are dependent on operating leases as a significant source of finance will notice significant effects in their annual accounts.