Nederlandse Vereniging Leasemaatschappijen

Sir David Tweedie  
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Amsterdam, 3 December 2010

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inzake : comments on ED Leases

Dear Sir,

Introduction

The Dutch Leasing Association (NVL) responds to the opportunity to comment on the Exposure Draft on Lease accounting (ED Leases). The NVL represents all major Dutch equipment leasing companies, both bank-owned as well as the larger captive and independent lessors in the Netherlands. The combined 2009 production volume amounted to Eur. 4.5 billion, excluding the production volumes on car leasing which is reported separately by its sister organization VNA, the Dutch Automotive Leasing Association. Total production of NVL and VNA represent around 25% of annual investment volume in the Netherlands, in line with a mature leasing country.

Summary

In summary, the comments of the NVL focus on:

1. Fundamental review leading to a separate leasing standard
2. Restriction to contracted terms only
3. Accretion of residual value
4. Cost-benefit assumptions
5. Related items

The NVL has actively participated in formulating Leaseurope’s comments on the ED Leases and therefore refrains from answering the individual questions in the ED Leases. We refer to the response of Leaseurope.
1 Fundamental review leading to a separate standard

The NVL concludes that the road towards a new standard shows particular flaws in the academic approach resulting in weak and insufficient supported and persuasive arguments for change.

Scope
It is difficult to understand why the scope of the proposed standard is less than IAS 17, particularly in the area of intangibles. We cannot accept that for political reasons, in saving the convergence project, the lowest achievable common denominator is presented as the ultimate solution. Whereas, the concept of 'all leases on balance' stems from the early nineties of the last century, an enormous development such as the www and other IT-related techniques and services have taken on which should not be ignored by the new standard. Outsourcing is common practice for all kind of activities and will only grow further: call centers including equipment, in-house printing shops, etc. At the same time, not just because of intangible assets in scope, we advocate the on-balance presentation of leased assets and lease obligations in separate categories due to the specific nature of leases: to all users it would be clear what impact leasing has. Equally, we would prefer using specific captions in the statement of comprehensive income.

Transparency
We find the transparency arguments for lessees to come to one-on-balance-model strong. Equally, we cannot understand that at the same time for lessors a wild array of methods is introduced. Conceptually, this is in conflict with and even contradicts the assumptions and arguments used for lessees. We consider the lag of a real fundamental review at the start of the project, understanding the leasing products and hence its required accounting, the basis of this ED Leases. With a knowledge gap as to what the current operating lease product stands for, the proposed lessor accounting cannot but be impaired. In particular, the missing embedding of IFRIC4 in the roots of the proposed standard is crippling the current outcome. We appreciate that the IASB Board is unwilling to draw bright lines in a principle based standard; however, not being able to identify (operating) leases from services contracts is the major reason for the multiple methods suggested. On the one hand, exceptions are introduced to deal with identifiable target groups like manufactures/lessors, on the other hand models are introduced for the pure reason of addressing possible abuse, i.e the Performance Obligation model to avoid day-one profit taking.

Consistency
The proposed models for lessee and lessor accounting are mutually inconsistent when using multiple models. Even when comparing the model for lessors that comes closest to the model for lessee accounting, one can spot inconsistencies. A mirrored approach in combination with observing the typicality of a lease transaction, a fixed payment stream and a constant return via mortgage-based annuity calculations, in our opinion should be the outcome of the fundamental review. When performing this review, it will become apparent that it is the use and not the physical assets that counts. Still, without a clear definition of a lease versus a service contract, it doesn't automatically mean that a lease should always be on-balance. Therefore, the right-of-use model is not in all cases the answer.
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**Accounting impact**

When looking at fair representation of assets and liabilities and recognition of revenue, the proposed standard shows some remarkable effects:

- It forces extra loss taking in the early part of the transaction for lessees and extra profit take with lessors. This is against the interests of quite some parties: consider a hospital or other subsidy-focused entity of which the budget is set for 2011 based on 2009 annual figures; these lessees are severely impaired by high early costs and low late costs, then at reinvestment followed by high early costs again, etc.
- It proposes accounting as under current finance leases for both lessees and lessors; the linear depreciation of assets under a right-of-use model for lessees already imposed unwanted effect, not in line with the essence of a lease transaction, being fixed periodical payments. To augment this to all leases for both lessees and lessors is pursuing the wrong direction and defies simplicity.

- Lease transaction models in the proposal are incomplete: only simple leases are discussed; differences bound to development between tax- and commercial accounting are not taken into account; differences between expenses and cash flow are neglected; the residual value positions of lessors is not properly looked into (for the latter, please see point 3 below).
- Finally, the proposed standard is subject to acceptance of other proposed standards with debatable items, e.g. in the revenue recognition project.

**Basic need for change**

As argued in our response on DP Leases of 8 July 2009, then and now again, there is no single reason to change the current standard for lessors and we note that a new separation dooms between executory versus non-executory contracts that is not addressed in ED Leases to any relevant extent. The Board has not been successful in bringing forward conceptually supportive and persuasive arguments for change.

2 **Restriction to contracted terms only**

*The NVL strongly opposes inflating the balance sheet as a result of unsound valuation practises.*

Among Dutch lessors, strong unrest has come up when the proposal to include options, contingent rents and corrections for experience rather than contractual terms became apparent. This will result in inflating the balance sheet with values that could possibly never materialize nor could lead to obligations to pay, which is an undesired impact. One of the additional effects of inflated assets would be higher amortization costs at the lessee end which cannot be tied to any contractual obliged payments, thus extra depressing the results in the early part of the lease transaction. Lessors, on the contrary would never account for non-contracted rental streams as the outcome is uncertain at all times. Therefore, any form of mirroring lessee and lessor account is hampered automatically.

Where transactions are continued for an interim period of time until replacement has arrived, these extra payments should be seen as contingent rents, subject to apparent, though unavoidable timing effects. Costs (lessees) will be recognized as encountered.
3 Accretion of residual value

The NVL rejects the fixed residual value (RV) over time as indicated in the simple model in the ED Leases. The flaw in the model can easily be addressed by accreting the RV amount.

The simple model in the ED Leases is flawed where it concerns the fixed amount presented for the residual value with lessors. A lease transaction is engaged in on the specific request of the lessee; this includes the choice for the (in)tangible asset itself acquired by the lessor, its manner of use, circumstantial arrangements regarding access to the equipment by asset supplier and/or lessor, online monitoring, maintenance, etc. Also part of the circumstantial arrangements of a lease transaction is the agreed upon funding and its repayment schedule. As all of this is for the benefit of using the leased asset, the related costs, among which the full financing costs of the asset is for the expense of the lessee. The full financing costs include the funding for the investment in the asset, including the residual part for which no depreciation charge is made by the lessor.

Besides the above arguments, the costs for lessors up to the end of the lease are misrepresented and a lessor would be confronted with a last minute gain.

The only logical solution is accreting the RV amount at initial measurement to its nominal contractual value which at the onset of the transaction is the best estimate of its expected market value at expiry date.

4 Cost-benefit assumptions

The NVL is not convinced of the cost-benefit analysis presented in the proposals. The cost of implementing may be huge, the cost of sustaining the wild array of information (disclosures, management judgments, discussions on assumptions used and profit taken with auditors, analysts and other users of the accounts, not in the last place tax authorities) is overwhelming while not providing any additional insight in nor change to the economics of the transaction itself.

The Board is on really thin ice when suggesting sufficient robustness to the cost-benefit paragraphs. It simply is not the case. Most depressing, a simple, straight forward product (once the choice for operating or finance lease is made, which is once at the start only), is transformed into a multiple calculation- and disclosure beast without any substantive improved information for outsiders.

5 Related items

The NVL likes to point out that the impact on calculations for tax accounting and capital requirements (especially bank-owned lessors) will be rather substantial and itself will be an additional and ongoing burden that needs to be included in the cost-benefit discussion.

Two of the related items that the Board likes to abstain from as it is not a standard setters domain, is taxation and capital requirements.
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With the introduction of a new leasing accounting concept, each individual tax authority has to consider how to address the outcome of the calculations of its customers/taxpayers. So not only the taxpayers are confronted with costs, but equally the various authorities are. With the implied front loading of costs by lessees, it is questionable whether tax authorities will follow the commercial outcome (result) and hence an additional cost burden will appear for the taxpayers who are obliged to make specific calculations and include deferred tax elements in their balance sheets.

The Capital Requirement Directive / Basel III initiatives will make banks look twice to consider inflating gross assets, which are normally subject to the CRD calculations. The impact might be mitigated when regulators and standard setter could align their time tables.

Conclusion

The NVL strongly encourages the Board to reconsider its current ED Leases in order to make it more robust and to incorporate above included comments. We suggest to include leases on-balance in separate categories for assets and liabilities.

Yours sincerely,
Nederlandse Vereniging van leasemaatschappijen - NVL
on behalf of,

G.M.H. van Lokven LL.M
Secretary General

E.J.H. Junk RA
Chair Accounting Committee