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Consequences of a New Lease Standard

- *a qualitative study from a company and auditor perspective*

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ABSTRACT

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Title: Consequences of a New Lease Standard – a qualitative study from a company and auditor perspective

Background and discussion: The current lease standard, IAS 17, has been accused for causing an unfaithful accounting where the comparability between companies is unclear. In order to overcome the issues, the IASB and FASB have decided to introduce a new lease standard. In an exposure draft to the new standard, the most evident change is that the distinction between the operating and finance lease will be removed, which implies that all lease transactions will be shown on the balance sheet. This proposal is however highly disputed as it will have consequences for companies.

Purpose: The purpose of the present study is to understand what consequences the new lease standard will have on companies using IFRS and operating lease, and to find out if companies have conducted any preparations. The study also aims to illuminate why companies lease and if they actively strive for a certain lease classification.

Method: The present study is conducted with a qualitative approach. Interviews have been performed with five companies and one auditor. In the selection of the companies and the auditor, a purposive sampling method was used.

Result and conclusions: The change of the lease standard will have consequences on companies using IFRS and operating leasing. The consequences will include increased balance sheets, changed debt structures, an increased administrative burden, a need to purchase new IT-systems, educational efforts and changes in companies' lease behavior. How comprehensive these consequences will be is very individual. The companies in the present study are not particularly worried about the effects of the new lease standard. The findings suggest that not many preparations have been conducted.

Further research: The authors of the present study believe that more qualitative research on the consequences of the new lease standard is beneficial, especially as there will be a re-exposure in 2012. However, succeeding research is suggested to take the perspective of auditors or analysts.

Key words: IAS 17, IFRS, Exposure draft, lease classification, new lease standard, consequences

PREFACE

We would like to thank all persons who have made it possible for us to conduct this study: Our tutor Andreas Hagberg for guidance and support, Pernilla Lundqvist for a fruitful meeting in the initial phase of the study, our opponent group who has made us observant of things in need of improvement and our much appreciated respondents who have dedicated time for taking part in the study. Last but not least, we would like to thank each other for an interesting and instructive period characterized by a well-functioning collaboration.

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DEFINITIONS

IASB	The International Accounting Standards Board. An independent standard setting organization situated in London. Issues IFRS.
FASB	The Financial Accounting Standard Board. An American standard-setter, which issues most of the rules representing US GAAP.
IAS	International Accounting Standards. The set of standards issued by the predecessor of IASB, IASC.
IFRS	International Financial Reporting Standards. The set of standards issued by the IASB.
US GAAP	United States Generally Accepted Accounting Principles. The set of standards applied in the US.
Lease	“A lease agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.” - IAS 17

1. INTRODUCTION

This chapter will present the background on lease accounting and the planned changes of the lease standard. A discussion on the topic will also be presented, resulting in the purpose of the study.

1.1 BACKGROUND

Real estate and equipment leasing are central components of financing strategies in many companies. Leasing can be used to minimize risk, optimize cash flow, reduce cost or improve key financial ratios (Berk & DeMarzo, 2010). Not surprisingly, leasing is a large and rapidly growing industry all over the world. In Europe 2010, leasing accounted for 292 billion dollars compared to 274 billion in 2009 (leaseurope.org). A similar pattern is recognized in the US, and in 2008 US companies leased productive assets for more than 250 billion dollars (Berk & DeMarzo, 2010). Hence, leasing is globally an important source of financing and therefore, lease accounting standards of high quality are required (Exposure Draft).

Currently, all listed companies within the European Union are required to follow the accounting standards issued by the International Accounting Standard Board (IASB). IASB is an organization whose main objective is to develop a single set of high quality and globally accepted reporting standards called IFRS (ifrs.org [a]). When IASB and the Financial Accounting Standards Board (FASB) jointly launched a convergence project in 2002, a significant step towards international harmonization of the accounting was taken (fasb.org [a]). The goal of the project was to improve poorly functioning standards that also differentiated significantly between the IFRS and US GAAP framework. Several projects were put on the agenda for reconsideration and one of the projects was IASB's current lease standard, IAS 17 (pwc.com [a]).

IAS 17, classifies a lease as either operating or finance. The difference between the two leases is that the finance lease causes an asset and a liability on the balance sheet, while the operating lease only is disclosed as an expense in the footnotes (IAS 17: §20, §35). The finance lease could thus be compared to a debt financed purchase, whereas the operating lease could be compared to a regular rent agreement (Dag Smith, 2006). The main thought with IASB's accounting standards is that they should be based on principles. Therefore, the standards aim to be guiding rather than controlling. This is also the case with

IAS 17, which allows companies to evaluate lease transactions themselves in order to classify lease contracts (Marton et al, 2010). IASB provides some guiding criteria when a finance lease should be recognized. However, the criteria provided are ambiguous and in order to achieve a specific classification, they can be exploited. This is also likely to occur with the current lease standard as companies have incentives to classify lease contracts as operating rather than finance (Exposure draft). By classifying lease contracts as operating, companies are able to obtain assets while maintaining an unaffected debt structure and thus, make the company look financially stronger (Marton et al, 2010).

IASB's framework defines four qualitative characteristics that the financial reports need to fulfill to be useful for financial users. The characteristics are: *understandability*, *relevance*, *reliability* and *comparability*. Comparability means that financial users should be able to compare the financial reports of different entities in order to evaluate their relative financial position (IFRS-volymen § 39, 2010). IAS 17 is not consistent with the framework as leasing transactions might be classified unfaithfully. As a result, the comparability between companies will be lower, and financial users have to adjust companies' balance sheets for the operating lease in order to capture the true debt structure (Exposure draft). However, it is hard to perform accurate calculations as the financial reports often present insufficient information about companies lease transactions (Knubley, 2010).

In 2010, an exposure draft (ED) of a new lease standard was presented. Since then, tentative changes have occurred and in 2012, a re-exposure is to be expected. However, the main change in lease accounting remains: the classification between operating and finance lease will be removed. Instead, all lease transactions will be shown on the balance sheet. Lessees will thus recognize a right-to-use asset and a liability for every lease agreement, resulting in all present lease agreements to be considered finance (Exposure draft). There is one exception though. The so-called short-term lease, with a maximum lease term of one year, will still be accounted for as the current operating lease (kpmg.com). With the change in lease accounting, IASB believes that their most important financial user (IFRS-volymen § 10, 2010), the investor, will be provided with more reliable information about an entity's leasing transactions. Hence, the comparability is expected to be enhanced. This is important for investors, as it will help them in their economic decision-making (Exposure draft).

1.2 DISCUSSION

The proposed change of the lease accounting implies that financial users finally will be able to rely on an entity's leasing transactions (Exposure draft). However, the change in lease accounting is a controversial topic as there probably will be consequences for the companies applying IFRS. When the new lease standard is introduced, all lease transactions except the short-term leases will give rise to a right-to-use asset and a liability. As a result, the balance sheets of affected companies will increase and offset changes on key financial ratios (Exposure draft). These consequences have been investigated long before the ED was published. In an early study, Beattie, Edwards and Goodacre (1998) reported that in Great Britain, operating leases represented a major source of long term financing. In the examined companies, the average amount of off-balance-sheet financing corresponded to 39% of the reported long-term debt. Companies with a substantial amount of operating leases could therefore expect to have their balance sheets and key financial ratios heavily affected by the new lease standard. In a more recent German study, Fülbier, Silva and Pferdehirt (2008) also showed that a capitalization of the operating lease would have an essential impact on key financial ratios. However, they found that the consequences would be highly limited to companies within the retailing industry. The reason for this is that retailers often lease large amounts of property. Deloitte (2010) has also investigated the ED and reported lower asset turnover ratios, lower return on capital, and an increase in debt to equity ratios, which could affect companies' ability to receive bank financing.

In comment letters to the IASB and FASB, affected companies have shown their concern about the new lease standard. In less than four months after the publication of the ED, more than 700 comment letters were received (ifrs.org [b]). Overall, the comment letters were negative towards the change. The Elex Group, an independent leasing company, argued in a comment letter that the administrative burden of the new lease standard would ruin the lease market. The cost of leasing would increase and outweigh the benefits (fasb.org [b]). Another comment letter expressed the worries for worsened key financial ratios, which could deteriorate a company's rating. Thus, it would be harder for companies to receive credits and undertake investments (ifrs.org [c]). However, it is uncertain if the impact of the new lease standard will be that dire. In a qualitative study by Bylock & Fredriksson (2011), it was concluded that the aviation industry is not likely to be affected to any greater extent, since its key financial ratios already are adjusted for operating lease in the financial statements. All in all, one can claim that there are disagreements regarding the consequences and the impact of the new lease standard.

1.3 RESEARCH QUESTIONS

According to IASB, the financial reports will be more useful as the comparability between companies will be enhanced with the new lease standard. However, the enhanced comparability is achieved at the expense of companies recognizing all lease agreements on the balance sheet. Consequences for the companies are therefore to be expected. The authors believe that further studies of the consequences are beneficial, as it seems to be an important and controversial topic with regard to the amount of comment letters and conducted research. This leads the authors to answer the following research question:

- What consequences will the new lease standard have on companies applying IFRS?

The research question will help the authors to achieve the purpose of the study.

1.4 PURPOSE

The purpose of the present study is to understand what consequences the new lease standard will have on companies using IFRS and operating lease, and to find out if companies have conducted any preparations. The study also aims to illuminate why companies lease and if they actively strive for a certain lease classification.

1.5 APPROACH

A qualitative approach has been applied as it is most appropriate with the purpose and the research questions. Interviews have been performed with five companies of various size and degrees of operating lease. To enhance the understanding of the findings a complementing interview also has been conducted with an auditor.

1.6 CONTRIBUTION

The present study can contribute by either verifying or increasing the knowledge of what consequences the new lease standard will have on companies using IFRS and operating lease. This understanding could be of practical importance for financial users and especially investors, whom the change in lease accounting is intended for. With help from the study, investors will hopefully broaden their understanding on how the companies they interact with could be affected by an implementation of the new lease standard.

2. FRAME OF REFERENCES

This chapter will present more detailed facts regarding the IASB, the current lease standard, its issues and the proposed changes in lease accounting. Furthermore, criticism against the new lease standard and prior research will be presented.

2.1 STANDARD-SETTERS AND STANDARDS – AN INSIGHT

2.1.1 IASB AND THE STANDARD SETTING PROCESS

The IASB, situated in London, United Kingdom, is an independent, not for profit private organisation working for the public interest (ifrs.org [a]). The organisation was formed in 2001 when it took over the tasks of its predecessor, IASC, after a reorganisation. The reorganisation was considered as necessary due to the heavy criticism that IASC had been exposed to in association with the growth of the organisation during the 1990's. The main points of criticism regarded staff shortages and the vague cooperation with other international norm-setters. In order to ensure its independency and to increase its competitiveness against other norm-setters, the IASC was reconstituted into the IASB. The new organisation's main tasks included the development of the so-called International Financial Reporting Standards (IFRS). The IFRS are a further development of the standards issued by IASC, which were called International Accounting Standards (IAS). All standards issued or revised (in a substantial way) after the reorganisation of IASC in 2001, are called IFRS. The purpose of the standards is to increase the comparability between companies in different countries and to be more stock market oriented than the IAS was. Further aims with the harmonized standards are to increase the flexibility and function of the capital market. This implies that unlisted companies, who are standing outside the stock market, are not required to apply IFRS (Marton et al 2010).

When starting the process of setting a new standard, IASB begins by considering their future agenda. In order to do this, the staff members of the organizations are given the task to investigate whether there are any standards that are considered particularly poor or exposed to dissatisfaction and criticism from other interested parties and standard setters (ifrs.org [d]). When the issues are identified, the decisions of whether to adopt them as new projects are discussed in public meetings. These public meetings are often held as either public hearings or round-table meetings. Public hearings are common during comment periods, since that is when they are considered as most useful. The public hearings imply that participants prepare short presentations that are followed by a question-and answer session. In public

round table meetings, participants are welcome to discuss and share their views on frequently asked questions (ifrs.org [e]).

Prior to reaching the decision of starting a new project, the IFRS Advisory Council and other standard setting bodies are invited to give their views on the matter. When the decision to start a standard setting process has been through, the IASB has to decide whether they should carry out the process on their own or together with another standard-setting organization, such as the FASB. The following step towards reaching a new IFRS involves public meetings that eventually result in publically issued ED:s. During the period succeeding the publication of the ED, stakeholders are given the opportunity to send comment letters to the IASB that are taken in consideration when deciding on a potentially revised ED or a new standard. At the point when the issues regarding the ED has been resolved and the IASB feels satisfied with the draft, the members vote on whether they should publish their final draft or not. If the majority of the members vote in favour of a publication, a new IFRS is adopted (ifrs.org [d]).

2.1.2 THE CONVERGENCE PROJECT BETWEEN IASB AND FASB

In 2001, the European Commission required all listed companies within the European Union to apply the IFRS-standards no later than 2005. Currently, the use of IFRS is allowed or required in more than 100 countries all over the world. However, the application may be different between countries and regions. The standards may be applied as published by IASB (e.g. India), as adopted by the European Union (e.g. Denmark) or as their local version of IFRS (e.g. Australia) (pwc.com [b]). Among the countries that have decided to reject the IFRS is the world's greatest economy, the United States of America. Instead of joining the widely used international accounting standards, they prefer to use their own set of standards, the US GAAP (US Generally Accepted Accounting Principles). Because of the practical difficulties arising when such influential international player as the US chooses to neglect accounting rules used by a majority of the world's countries, the convergence of US- and international standards have always been one of the main objectives of the IASB. A significant step was therefore taken in 2002 when the convergence project between IASB and FASB began. The goal was to improve both US GAAP and IFRS while at the same time removing the differences between the two sets of standards, i.e., making them compatible to each other (fasb.org [c]).

In two documents, the Norwalk Agreement (2002) and the Memorandum of Understanding (2006, updated 2008), the boards of the IASB and FASB describe what convergence means to them and explain

how they intend to achieve it (fasb.org [c]). In the Memorandum of Understanding, the IASB and FASB have decided on three fundamental principles that should characterize the convergence project. Firstly, they agree that a convergence of accounting standards will be best achieved and have the highest quality if the standards are developed over time. Secondly, it is stated that it is better to develop completely new standards instead of trying to eliminate differences between standards that are both in great need of improvement. The third and final principle is that in order to serve and satisfy investors, convergence should be sought by replacing poorly functioning standards with new, jointly produced ones (fasb.org [a]). The lease standard, IAS 17, was one of the projects selected for reconsideration in 2006 (pwc.com [a]).

2.2 A PRESENTATION OF IAS 17 – LEASES

2.2.1 THE PRESENT LEASE STANDARD IAS 17

The present lease standard IAS 17 defines a lease as *“an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time”* (IAS 17:4). A contract that fulfills the definition of a lease will be classified as either finance or operating. What separates the two leases is that the former gives rise to an asset and a liability, while the latter only causes rent payments. The finance lease can, therefore, be compared to a debt financed purchase, while the operating lease is similar to a regular rent agreement (Dag Smith, 2006). Whether the lease is classified as finance or operating depends on if substantially all risk and rewards incidental to ownership of the asset has been transferred from the lessor to the lessee (IAS 17:7). This means that the one carrying the risk and rewards associated with the asset recognizes a finance lease and, therefore, an asset in the balance sheet. Legal ownership is irrelevant which leads to a central conclusion in IAS 17: *lease agreements shall be evaluated on the substance of the transaction and not the form of the contract*. In order to decide the classification, both the lessor and the lessee are allowed to evaluate the substance of the transaction (Marton et al, 2010). However, IAS 17:10, provides guidance of situations that individually or in combination leads to a finance lease:

- a. the lease transfers ownership of the asset to the lessee by the end of the lease term;
- b. the lessee has the option to purchase the asset at a price that is exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- c. the lease term is for the major part of the economics life of the asset even if title is not transferred;
- d. at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- e. the leased assets are of such specialized nature that only the lessee can use them without major modifications.

However, the guiding examples are not always ruling. If it stands clear from other features that the lease does not transfer substantially all risk and rewards, the lease will be classified as operating (IAS 17:12). The lessee and the lessor are also independent of each other and as a result the lease contract can be classified differently between them (IAS 17:9).

The amounts recognized in the balance sheet, when a lease is classified as finance, should be the lowest value of either the fair value or the present value of the future lease payments (IAS 17:20). As stated, the operating lease does not affect the balance sheet. Instead IAS 17 requires lessees to disclose information about future operating lease payments in the footnotes.

2.2.2 THE ISSUES WITH IAS 17

IAS 17 allows the lessee and the lessor to evaluate the substance of the transaction in order to classify the lease contract as either operating or finance (Marton et al, 2010). As mentioned, a major flaw with the current lease standard is that companies have incentives to classify contracts as operating. The finance lease gives rise to an asset and a liability, while the operating lease leaves the balance sheet unaffected. This is of central importance concerning IAS 17 since it has major consequences for key financial ratios. Classifying a lease contract as finance will always worsen the debt to equity ratio and the return on assets compared to the operating lease, which leaves the two ratios unaffected, or even improves the return on assets if the operating lease generates a positive net income. Hence, it always will be more favorable for companies to classify lease contracts as operating than finance (Marton et al, 2010). Important to note is, that the benefits and costs provided by the lease, whether it is operating or

finance, are equal. The advantage in key financial ratios provided by the operating lease is merely an accounting illusion (Marton et al, 2010). The issue is illustrated in the following example:

Initially company X has assets worth of 100 CU generating 10 CU net income. The assets are financed with 50 CU equity and 50 CU debts. Company X decides to expand by leasing a new machine worth 50 CU. The net income generated increases to 20 CU. The initial key financial ratios are a debt to equity ratio of 1.0 and a return on assets of 10%. As seen in figure 1 and 2, the debt to equity ratio doubles and the return on assets increases to 13,3% if company X classifies the lease as finance. However, classifying the lease as operating leaves the debt to equity ratio at its initial level while the return on assets increases to 20%. The operating lease is, therefore, a possibility for off-balance-sheet financing.

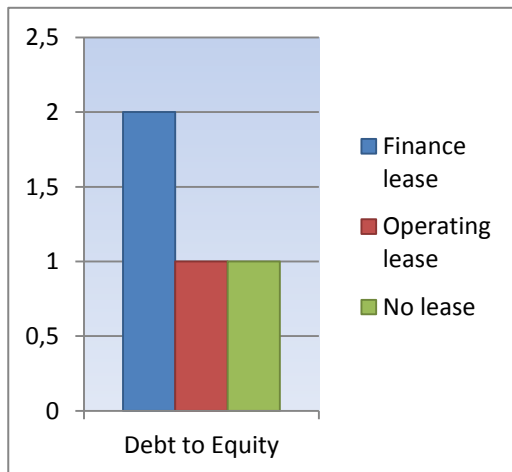


Figure 1

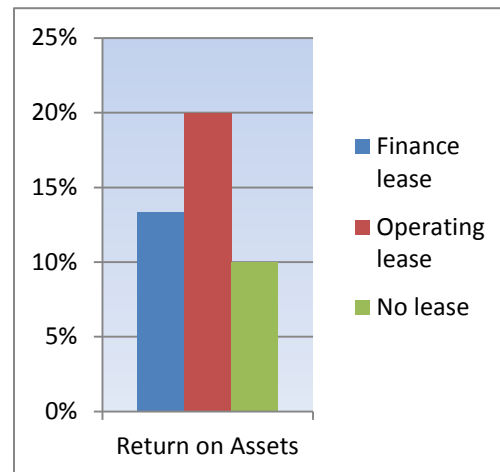
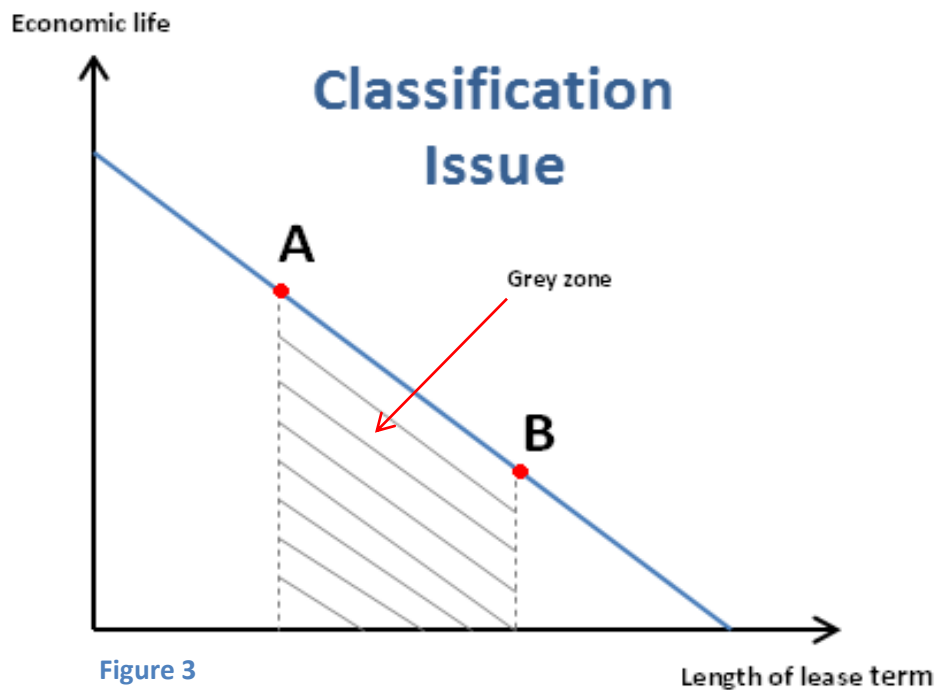


Figure 2

It is understandable why companies are tempted to classify leases contracts as operating. This can be achieved by formulating lease contracts that avoid the criteria in IAS 17:10 and thus leave the risk and rewards with the lessor. An example is the relation between the length of the lease term and the economic life of the asset (criteria c). As illustrated in figure 3, case A would normally lead to an operating lease, since the lease term is minor in comparison to the economic life of the asset. Case B, on the other hand, represents the opposite situation and would normally lead to a finance lease. The area in-between the two presented cases is, however, a grey zone, open for subjective judgments regarding the lease classification. As a result, two very similar contracts, or even identical ones, can end up being classified differently (Marton, 2010).



From an accounting perspective the current situation is problematic. The objective of the financial reports is to provide financial users with information of an entity, which is useful in order to make economic decisions (IFRS-volymen, 2010). IAS 17 fails this objective since some of the current leasing transactions are likely to be classified unfaithfully (Exposure draft). As a result, the comparability between companies impoverishes and financial users have to adjust the balance sheets for operating leases to make correct economic decisions. The adjustments are performed by discounting the future operating lease payments presented in the footnotes. The discounted amount is then added on to the balance sheet in order to show the companies true debt structure. However, the information presented in the financial reports is often insufficient and, therefore, it is difficult to make accurate calculations (Knubley, 2010).

2.3 BACKGROUND TO THE NEW LEASE STANDARD

The initial change of the current lease standard started in the 90s with a workgroup called the “G4 + 1”, consisting of accounting representatives from Australia, Canada, New Zealand, the United Kingdom, the United States and IASC. The workgroup examined the issues concerning the current lease standard and

how they could be solved. The result was presented in two reports and concluded that the current distinction between an operating and a finance lease caused a worsened comparability and hence, less useful financial reports. The main suggestion was that operating leases also should give rise to an asset and a liability, but to a more limited extent. The results obtained by the G4+1 group did not have any intention or formal ability to serve as an ED for a new lease standard (Robert C. Lipe, 2001). In 2006, however, IASB and FASB decided to replace IAS 17 with a new lease standard and four years later, an ED was released with a similar objective and solution: to increase the comparability by removing the operating lease (www.icsc.org). The exposure draft was heavily criticized (see 2.5) and a re-exposure is therefore to be expected in 2012 (IFRS.org [f]). The main proposal of removing the operating lease will remain along with several other features. The majority of the changes in the re-exposure are intended for the lessor, however, this will not affect the present study as it deals with the lessee (kpmg.com).

2.4 THE PROPOSED CHANGE OF LEASE ACCOUNTING

The main difference between the new lease standard and IAS 17 is the removal of the lease classification as either operating or finance. Instead lessees will apply a right-to-use model, giving rise to an asset and a liability (Exposure draft). The right-to-use model will therefore correspond to the current classification of finance leases. The difference between the two lease models is, however, based on how the lease asset is recognized. Under IAS 17, a lessee shall recognize an asset when substantially all risk and rewards are transferred to the lessee. The new lease standard will instead recognize an asset once the asset definition in IASB:s framework applies. *“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”* (IASB, Framework §49). This means that all contracts defined as a lease automatically will give rise to an asset. The corresponding logic also applies for the lease liability. The new lease standard will therefore be coherent with the asset definition in the IASB framework, which IAS 17 is not. IASB and FASB believe that the comparability between companies will be enhanced with the right-to-use model since leasing transactions no longer can be classified unfaithfully (Exposure draft). However, the new lease standard is not entirely consistent. An exception is the short-term lease, which is a lease with a maximum lease term of 12 months, including options to renew or extend. The short-term lease will not be recognised on the balance sheet. Instead, lessees will recognise lease payments similar to the current operating lease (KPMG.com).

The new lease standard will also require more comprehensive evaluations when determining the size of the right-to-use asset and the lease liability. Companies will have to make probability assessments of how long the lease term is most likely to become. Furthermore, lessees will be required to reassess the lease liability and the right to use asset *“if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period”*. For instance, firms will have to pay attention to probable changes in lease terms throughout the reporting period (Exposure Draft). Moreover lessees are required to present both qualitative and quantitative information in the financial reports about the lease transactions. General descriptions of the lease and existence and terms of options and renewals are examples of what have to be presented.

2.5 CRITICISM AGAINST THE NEW LEASE STANDARD

Naturally, the main criticism concerning the new lease standard have focused on the capitalization of the operating lease, as it would increase companies' balance sheets and debt structures. According to the “Confederation of Swedish Enterprise”, the Swedish retailer KappAhl, expects to have their balance sheet increased with 100 percent (swedishbankers.se). As a result, existing debt covenants could suddenly be violated. This could mean that companies would have to renegotiate existing debt covenants to exclude lease agreements (ifrs.org [g]). Moreover, companies expressed worries that the new lease standard would make it harder to receive credits (swedishbankers.se). There has also been a discussion about how representative it is to include all lease agreements on the balance sheet. Companies in the retailing- and hotel industry believe that the current proposal does not reflect their business activities, as owning property is not part of those (ifrs.org [h]).

Criticism has also been pointed towards the short-term lease. Some companies believe that the existing “bright lines” in the classification between operating and finance will be replaced by new ones, as companies will start shortening lease-terms in order to take advantage from the short-term lease, which corresponds to the current operating lease (ifrs.org [h]). In a comment letter, an auditor further criticizes the fact that the lease-term should decide whether or not an asset is recognized on the balance sheet. In an example he shows the absurd consequences the short-term lease would have on financial statements: Consider a drilling platform leased for \$ 500 000 daily. Leasing the platform for one year and one day would mean that \$ 183 000 000 would have to be recognized on the balance sheet, while leasing it for 364 days would leave the balance sheet unaffected (ifrs.org [j]). In comment letters, companies also have expressed that the new lease standard would change their lease behaviour, and

some assets would instead be purchased. However, it was also reported that companies will continue their leasing activities, unaffected of the new lease standard, since lease reasons are of economic nature, including optimization of cash flows and flexibility (ifrs.org [i]).

Moreover, companies have also criticized the new lease standard, since the administrative burden would increase considerably (ifrs.org [h]). Educational efforts in the new lease standard, new IT-systems, changes to control and processes systems and increased expenditure in consultant fees were common examples. This is further supported by O'Donovan (2011) who has criticized the new lease standard for being too complicated. He also argues that companies, with a lot of lease agreements, will have to invest large amounts in new IT-systems and in increased management time since more detailed estimates regarding the lease liability and the right-to-use asset have to be conducted in comparison to IAS 17.

However, the lease standard has also received positive comments. Hewlett-Packard (HP) admits that there currently is an issue with IAS 17 and lease contracts being classified unfaithfully. According to HP, it is motivated to change the lease accounting but rather by improving the current standard (fasb.org [c]). A publisher at a leasing paper also argues that the change in lease accounting is motivated, as it will remove the subjective elements. However, in contradiction to HP, he agrees with the IASB that an entirely new standard is required (fasb.org [d]).

2.6 PRIOR LITERATURE

In a number of studies, the presumed effects of the new lease standard have been investigated. In an early study, Imhoff, Lipe and Wright (1991) showed that capitalizing the operating lease in seven selected companies would have major consequences for key financial ratios. Moreover the researcher found that return on assets would decrease with 34% for high-lease companies, while only 10% for low-lease companies. A similar pattern was seen regarding debt to equity, which would increase with 191% for high-lease companies, while only 47% for low-lease companies (Imhoff et al., 1991). A similar but larger study of 232 listed companies in the UK reported that operating leases represent a major source of long term financing (Beattie, Edwards & Goodacre, 1998). In the examined companies, the average amount off-balance-sheet financing corresponded to 39% of the total reported long-term debt. Furthermore, Beattie et al (1998) showed that a capitalization of the operating lease would affect six of nine examined key financial ratios. Companies with a substantial amount of operating leases could

therefore expect to have their balance sheets and key financial ratios affected by the new lease standard. The study by Fülbier, Silva, Pferdehirt (2006) also shows that a capitalization of the operating lease would have an essential impact on key financial ratios but highly limited to companies within the retailing industry.

More recently, Deloitte (deloitte.com) confirms that effects of the new lease standard would include lower asset turnover ratios, lower return on capital, and an increase in debt to equity ratios, which could affect companies' ability to receive bank financing. IBM (2012) in a worldwide survey showed that companies expect to reassess their leasing strategies and change their current accounting processes. According to 75% of the respondents, retraining staff in the new lease standard would also be necessary. Moreover, it was found that some companies can endanger to violate debt covenants because of an increased debt structure. Also, Deloitte has reported that companies categorized as large industrial companies and big-box retailers would consider changing financing method from leasing to purchasing properties (Mortgage banking, 2011).

Research has also been conducted on how creditors view operating and finance leases. Hartman and Sami (1989) asked 90 participants what interest rate they would charge a company with (a) no leases, (b) moderate or substantial amounts of finance lease, or (c) moderate or substantial amounts of operating leases. In the study, it was concluded that the company with a substantial amount of finance leases (b) would be charged a higher interest rate than the other two options. This study supports the fact that companies have incentives to finance with operating lease. However, the study is old and it is highly possible that creditors today have a better knowledge of leasing than in the 80s. This is also supported by the fact that Standard & Poor's *Corporate Ratings Criteria* (2008) nowadays include adjustments for operating lease.

3.METHODOLOGY

This chapter will present information on how the study was conducted in order to answer the research question and fulfill the purpose. Furthermore, the limitations and the trustworthiness of the study will be discussed.

3.1 RESEARCH APPROACH

The research approach should be selected with regard to the purpose of the study and the research questions (Trost, 2011). The two research alternatives are: a qualitative approach that intends to understand a phenomenon and a quantitative approach that rather intends to analyze relationships between variables (Trost, 2011). In accordance with the purpose of the study, the authors believe that a qualitative approach would be the most appropriate. Furthermore, a small sampling will be used in the study, which also is consistent with the qualitative approach. Important to know is that a qualitative study is subjective and context depending.

3.2 SELECTION

3.2.1 SELECTION OF COMPANIES

The selection of companies and respondents has been conducted with a purposive sampling method. Thus, a strategic selection was conducted with regard to certain prerequisites and key characteristics. Prerequisites included: the application of IFRS, since companies applying IFRS are required to follow the new lease standard, and the usage of leasing. A key characteristic in the selection of companies was the usage of operating lease, as it is reported that companies using this lease classification will be most affected by the new lease standard (Fülbier, Silva, Pferdehirts, 2006; Exposure draft). However, the authors wanted to achieve a differentiated picture of what consequences are to be expected and thus, companies with different degrees of operating lease were of interest. Furthermore, it is reported that companies with a lot of lease agreements are expected to be more affected than companies with few lease agreements (O'Donovan, 2011). The authors expected large companies to have a greater number of lease agreements compared to small companies, and therefore, in order to obtain a variety of the data, both large and small companies were included. As face-to-face interviews were preferred, companies situated in Göteborg were targeted. Out of these criteria, a list with eight possible candidates was compiled. However, four of the companies rejected to participate in the study and, therefore, the

authors also included a company from Stockholm. In total, five companies participated in the study (see 3.2.2), which was considered sufficient for the purpose.

3.2.2 DESCRIPTION OF COMPANIES AND RESPONDENTS

AB Transatlantic: a shipping company listed on OMX Stockholm Small Cap. The company acts both lessor and lessee. The amount of operating lease payments is substantial compared to the amount of assets (Annual report Transatlantic, 2011). The respondent Jonas Enander works as financial manager.

AB Volvo: a diversified manufacturer of trucks, buses, construction equipment, drive systems for marine- and industrial applications and aerospace components. The company is listed on OMX Stockholm Large Cap and acts both lessor and lessee. The amount of operating lease payments is minor compared to the amount of assets (Annual report Volvo, 2011). The respondent Sofia Lundquist works as IFRS specialist.

SCA: a manufacturer of paper and hygiene products, listed on OMX Stockholm Large Cap. The company acts lessee. The amount of operating lease payments is minor compared to the amount of assets (Annual report SCA, 2011). The three respondents *Lisbeth Sandberg*, *Ing-Marie Pilebjer-Bosson* and *Ola Svensson* work as financial controller, IFRS expert and within the treasury department.

Stena RoRo: a shipping company that is part of Stena AB. Stena RoRo acts mostly as lessor but also lessee to a small extent (Annual report Stena AB, 2011). The two respondents Anders Bäckelin and Anna Forshamn work as business controller and group financial controller.

Elanders AB: a printing company listed on OMX Stockholm Small Cap. The company acts only lessee. The amount of operating lease payments is substantial compared to the amount of assets (Annual report Elanders, 2011). The respondent Fredrik Einarsson works as group reporting manager.

3.2.3 SELECTION OF RESPONDENTS

The company respondents were selected with regard to their knowledge about the new lease standard and what effects it would have for the companies. The respondents are of different backgrounds and

work as IFRS specialists, controllers, financial manager, group reporting manager and within the treasury department. Some companies have participated with several respondents, skilled in different areas concerning leasing and the new lease standard, while others only participated with one. Hopefully, it has provided a variety of aspects of the phenomenon.

An auditor, Helen Svärdröm working at PwC, skilled in IFRS and the new lease standard, has also participated in the study. Svärdröm was selected since she was recommended by a personal contact at PwC. The authors believe an auditor's knowledge on the new lease standard would be an interesting and neutral complement to the data collected from the companies.

3.3 DATA COLLECTION

3.3.1 SEARCH FOR LITTERATURE

The data used to construct the frame of references was mostly gathered from IASB's website, where the lease ED is to be found. Comment letters from the IASB's website were also retrieved and studied in order to understand the criticism concerning the ED. Information about the standard setting process was collected from the same source. The current lease standard, IAS 17, was obtained by accessing the database "Far Komplet". To better understand the current lease standard, relevant chapters in "*IFRS – i teori och praktik*" were used. To be updated on the so far tentative changes, a useful article by KPMG was retrieved from their website (*IFRS Leases Newsletter - issue 8, September 2011*). In order to get information about prior research of the new lease standard, a general search on Google was performed. The key words typed were "lease account research" which led the authors to a study by Lipe (2011). This was an important study as it referred to other studies on the topic (Imhoff et al, 1993). Earlier student theses have also been searched for using the university database GUNDA. Retrieved studies were Bylock and Fredriksson (2011) and Jonasson and Strand (2011). The studies helped the authors to find references like Beattie et al. (1998) and Fülbier, Silva and Pferdehirs, (2008).

3.3.2 INTERVIEWS

The empirical data collection has been conducted by performing semi-structured interviews once with five companies and one auditor. Each interview lasted for 30–45 minutes. The authors performed face-to-face interviews, as it decreases misunderstanding and provide a better opportunity to ask follow-up questions (Bryman & Bell, 2005). All but one interview was performed face-to-face. The sixth interview, with SCA, was performed via telephone due to the long distance between their headquarters in

Stockholm and the authors' residence in Gothenburg. It is however not considered that this divergent method affected the outcome of the interview. According to Hartman (2004), the semi-structured interview technique is characterized by a high standardization and a low structure. As a result, a respondent shall be asked a series of questions in a strict order with the possibility for open answers. In accordance with Hartman (2004), the frame of references and the research question, a questionnaire with seven questions was constructed and used for the interviews. The interviews were conducted with respondents of different positions and experience. All the interviews, except SCA, were conducted at the respondents' headquarters, where they could feel at ease, which hopefully contributed positively to the result.

As a preparation, the questionnaire, including a brief description of the purpose of the study, was sent to the respondent some days before the interview. Also, the authors prepared themselves by studying the relevant information presented in the annual reports of the companies. An important element was to learn the terminology used in the specific businesses. A funnel approach was conducted within the interviews (Hartman, 2004). This means that the interviews started with a warm up discussion about the respondents work experience before moving on to the questionnaire. During the interviews spontaneous questions and prompts were employed. The interviews were also tape-recorded and transcribed verbatim by the authors.

The questionnaire used consisted of 7 main questions and is presented below.

- What do you lease?
- Why do you lease?
- How do you formulate the lease contracts?
- What is your experience on the current lease standard, IAS 17?
- What is your opinion on the new lease standard?
- What effects will the new lease standard have on your company?
- Have you performed any preparations for the new lease standard?

The auditor Helen Svårdström was not asked the company specific questions presented in the questionnaire. Instead, she was asked questions concerning the potential consequences of the new

lease standard and was also given the opportunity to give her view on the matter. This gave rise to an interview that was more similar to a discussion.

3.5 METHOD LIMITATIONS

The method in the present study is associated with some issues. Performing interviews puts a lot of responsibility on the researcher, since the questions asked are vital for the findings. To be able to ask relevant questions, the authors have studied both prior research and the new lease standard. This is, however, no guarantee that the right questions have been asked. Since each qualitative study has its own premises, the findings are generally not transferable to a whole population (Bryman & Bell, 2011). Especially not in the present study as the sample size is limited and saturation is difficult to obtain. Consequently, the findings in this study are not transferable to all companies using IFRS at large, but hopefully they will contribute to a broader understanding of the phenomenon.

3.6 TRUSTWORTHINESS

In order to achieve trustworthiness, the authors of the present study have conducted certain steps. To minimize the risk for misunderstanding and loss of data, all interviews were recorded and transcribed verbatim. A member-check has also been performed in order to validate the findings. Furthermore, the two authors have independently and together, analyzed the data. Research on qualitative studies and trustworthiness highlight the importance of replication (Bryman & Bell, 2011). Because of the nature of the qualitative study it will be impossible to fully replicate the present study. However, the authors provide the reader with detailed information on how the present study was conducted. Acting neutral and thus avoiding bias is also of importance. The authors have no relevant past experience or pre-understanding of the companies or respondents that could affect the findings. It is also, as mentioned in the method limitations, questionable if the findings from the six interviews can be generalized onto a whole population. Although, saturation was not fully achieved some interesting findings could be reported.

3.7 ALTERNATIVE METHOD

The qualitative study that the authors have chosen to conduct includes interviews with five companies and one auditor. A qualitative method has been believed to give the authors a chance to receive detailed answers and the opportunity to conduct a deep analysis of the participating companies.

However, the qualitative method is not the only method that could have been applied. An interesting alternative would have been to apply a mixture of a qualitative and a quantitative method. The complementing quantitative part of the study, tentatively conducted through a questionnaire survey, could have included a greater and wider range of companies. Such a questionnaire survey would have made it possible for the authors to generalize the answers, since several companies in the same industry would have been able to participate in the study. In the present study, where a qualitative method is chosen, such generalizations are impossible due to the small number of participants. A questionnaire survey would possibly also have given more precise answers compared to solely relying on qualitatively conducted interviews.

4. FINDINGS

This chapter will present the findings gathered from the interviews in accordance with the purpose of the study. The companies will be presented first, followed by the auditor.

4.1 THE COMPANIES

4.1.1 WHY LEASING IS USED AND HOW LEASE CONTRACTS ARE CLASSIFIED

Transatlantic AB: Transatlantic is both lessee and lessor of ships. The company also lease real estate, but in a very small proportion compared to the expenses related to the ships. According to Enander, leasing is a way of financing the activities of the company. The alternative to leasing would be to acquire an asset through equity. Transatlantic chooses leasing as a source of financing rather than purchasing whenever it is considered more beneficial.

When Transatlantic chooses to lease, the preferred lease classification is operating. The explanation is that they do not want the lease in the balance sheet. Since the cost of acquiring a ship normally is between 400-500 million Swedish Kronor, the difference in having a ship on or off the balance sheet is vital, both for key financial ratios and on the debt structure. What determines whether a contract should be classified as operating or finance depends on an overall assessment. If Transatlantic leases an asset over the greater proportion of its economic life, the lease is normally considered as finance. The classification is also dependent on the economic situation in the society. During periods, when there is a surge of capital on the market, it is more common that the lessor is willing to carry the risk associated with the lease. However, due to the general risk averseness in the capital-intensive shipping industry, operating leases are not very common. An exception was the years before the current financial crisis, when there was much capital and many operating lease contracts were conducted. Transatlantic currently have few long-term operating lease contracts.

AB Volvo: At AB Volvo there is an extensive amount of lease contracts. Most leases are small objects such as coffee machines and office equipment, but the company also leases cars and real estate. Real estate is only leased to a small extent though, due to the fact that Volvo AB has its own real estate company. This implies that they own most buildings and property related to their operating activities. The reason why leasing is used is of financial character as it sometimes is economically beneficial to lease instead of purchasing assets. Another reason is that some assets are only required for a short period of time and then leasing is more flexible than purchasing.

Lundquist and a colleague are the ones who are examining agreements and determine whether to classify lease contracts as finance or operating. The idea is that all subsidiaries, at least at an initial stage, should contact them and use the internal knowledge at Volvo AB. At this stage, their audit firm is only contacted if uncertainties are encountered or if reconcilements are needed. When classifying the contracts, the criterions in IAS 17 are strictly followed. Even though there are many indications saying that a contract should be classified as finance, there is often a possibility to re-negotiate it to an operating one. The formulating of the lease contracts is usually characterised by an on-going dialogue between the lessor and AB Volvo. However, when re-negotiating, it is important not to fall into any of the “grey zones”. This is because the financial statements need to stay transparent and unchallenged. Lundquist explains that an operating lease classification is preferred when leasing real estate since AB Volvo does not want property to affect the balance sheet. The reason is that if they have to recognize a finance lease, they could just as well acquire the property through equity as both options end up on the balance sheet.

SCA: SCA holds a large amount of lease contracts mainly including real estate, productive assets (e.g. paper machines), vehicles and office equipment. Thus, the company leases a wide array of objects of various values. Leasing is used due to purely commercial reasons. As a consequence, leasing will always be used when it provides more benefits than purchasing does. One example is SCA’s head office, which is leased in order to avoid the risk associated with owning the property. Also, owning property in the centre of Stockholm is not a core activity of SCA. Instead, the company focuses its resources on what they are good at: producing diapers and other hygiene products.

SCA is well aware of the consequences that the lease classification between operating and finance have on key financial ratios. However, the company never aims to classify a lease contract as operating. SCA believe that it is unimportant since creditors and rating institutes already capitalize the operating lease payments disclosed in their footnotes. Whether the lease is operating or finance makes no difference since both contracts still are obligations. Finally, it is the auditors who decide how a lease transaction shall be classified. SCA highlights they would not pay for having auditors examining the possibility for a specific classification.

Elanders AB: Elanders leases mainly digital printing presses and real estate. The reason to lease the digital printing presses is based on the rapidly technological pace of the industry. In order to stay up-to-date, the digital presses have to be replaced every 3–4 years. Leasing is thus used for the flexibility it provides. Moreover, leasing the presses is beneficial because service and maintenance of the presses

are included in the lease contract. Real estate, including the custom-built head office in Mölnlycke, is leased since owning real estate is not considered as core activities of Elanders.

According to Einarsson, almost all lease contracts are signed locally by subsidiaries in different countries. Therefore, it is uncommon that Elanders, the parent company, is involved in the classification of lease contracts. Although Elanders prefers if the subsidiaries classify lease contracts as operating, it is no outspoken objective. Einarsson emphasizes that the main reason for classifying lease contracts as operating is that such contracts often include service and maintenance, which increase the economic benefits. As the lessor has a major impact on how the contracts are formulated, it is not that easy to achieve a specific classification.

Stena RoRo: Stena RoRo acts mainly as lessor but also to a minor extent as lessee. The reason to engage in leasing is purely commercial. Stena RoRo most commonly lend their ships, but at times they also build new ships, which then are leased to the customer. The cost of building a new ship is normally around one billion Swedish Kronor and a lease period around 7 years is required to ensure the deal. It is in Stena AB's interest not to grant the lessee any options to extend the lease term. However, the lessee often wants this possibility and the result will depend on the relative strength of Stena RoRo and the customer.

Determining whether a lease should be classified as operating or finance depends on the interpretation of the criteria in IAS 17. Stena RoRo prefers to classify lease contracts as operating as that makes them receive tax benefits. Furthermore, they believe that it is advantageous if the lessee also classifies an operating lease, as deteriorated key financial ratios will be avoided. In order to ensure future cash flows, Stena AB wishes to make long-term business. Classifications of finance leases would jeopardise this since it could cause financial difficulties for lessees.

4.1.2 CONSEQUENCES OF THE NEW LEASE STANDARD

Transatlantic AB: The new lease standard would increase the balance sheet and the proportion of debt at Transatlantic. However, the company believes that a decrease in key financial ratios will not make the company less attractive. Enander explains that creditors and investors already capitalize the operating lease payments disclosed in the footnotes – especially when investigating capital-intensive industries like the shipping industry. Leasing will also remain an important source of financing at Transatlantic. However, it is possible that Transatlantic will become keener to apply the short-term lease

in order to avoid having the balance affected. Enander highlights that having lease transactions of maximum one year off the balance sheet will not have a large impact, since these short-term leases are low in value compared to the long-term contracts. It is the long lease-term agreements that will strike hard at the balance sheet and this cannot be avoided. Further consequences would include education in the new lease standard and an increased administrative burden. However, it is not believed to be comprehensive as long as sufficient tools are available. These tools would include a new ledger used to follow all data and document the agreements and their lease-terms. Overall, Transatlantic believe that the new lease standard will not affect the company to any greater extent.

AB Volvo: AB Volvo will not experience any difficulties with changes in the debt structure or changes in key financial ratios. The balance sheet will increase, but not significantly, since AB Volvo is a small lessee compared to the total amount of assets. Lundquist has no deeper knowledge of the Group's debt covenants structure and can therefore not conclude upon any such effects. Otherwise, the consequences of the new lease standard are believed to be primarily administrative. This could for instance imply the purchasing of a new computer-system for registration of leases, which could cost up to a billion Swedish Kronor. It is also believed that there will be a need of consultants and personnel to examine all lease agreements. This need is especially likely to emerge if contracts have to be re-calculated, either retroactively, or from the date of implementation. Education in the new lease standard will also be necessary but will be conducted in-house. It is also highly possible that purchasing will become more frequent with the new lease standard but mostly for items of low value. Another possibility is to ease the administrative burden by using the short-term lease. Although some effects are expected, Lundquist is convinced that AB Volvo will get along well with the changed lease account standard. In fact, AB Volvo has been asked by researchers and the IASB to act as a "pilot company" in order to test the changes of the new lease standard. However, they believe they will remain fairly unaffected, which is why they have chosen to decline all such inquiries.

SCA: SCA has several lease contracts, which implies that a changed lease standard would have consequences for the company. The balance sheet would increase in size and the debt structure would change but this would have no further consequences. SCA has no debt covenants and will therefore not experience any problems with creditors. Furthermore, SCA believes that the creditors and the rating institutes already pay attention to the operating lease disclosures. However, the major consequences would involve an increased administrative burden and high transition costs regarding e.g. new IT-systems. Changes in other IFRS standards are normally handled from the head office. However, the

change in lease accounting will require educational efforts from the top and all the way down to the local parts of the organisation as contracts often are entered on a local level. Leasing as a source of finance at SCA will not change dramatically. Yet, one consequence might be that lease objects of lower value, such as coffee machines, will be purchased instead since it would ease the administrative burden. SCA concludes that the consequences of the new lease standard are not likely to be particularly comprehensive, although there will be an increased workload initially.

Elanders AB: The new lease standard would increase the balance sheet and the debt structure of Elanders sharply. However, it would not have any further consequences as the company's debt covenants are built upon interest bearing debt. The reason for that is that the lease liability is not considered as interest bearing. The change in lease accounting is also not likely to affect the company's market value as it will not affect the company's ability to generate profits and cash flows. Hopefully, the investors are smart enough to understand the whole picture and not only focus on the changed debt structure. Also, the company will provide investors with information in the annual report about the changed debt structure when the new lease standard is introduced. Leasing as a source of financing would probably remain unchanged at Elanders. The company's approach is to do what is economically advantageous rather than what is advantageous for accounting purposes. Leasing is used for the previous reason. It is also uncertain whether the so-called short-term leases will be applied, as Einarsson believes the short-term lease will be a more expensive option than longer lease-terms. The need to purchase new IT-systems and modules could also be a consequence of the new lease standard. Since the subsidiaries in the countries where Elanders operate are very small, the employees are believed to do well without any comprehensive education on IFRS and the new standard. Sometimes, Einarsson says, the finance department at our subsidiaries consists of only one or two persons. Overall, Einarsson believes that the new standard would not affect Elanders to any great extent.

Stena RoRo: The balance sheet and the debt structure will increase with the new lease standard. Stena RoRo has covenants but they will not be affected by the new lease standard. One key condition for Stena RoRo is that the customers neither can nor want to own ships. Whether the key conditions will be affected by the new lease standard or not is unclear. One scenario could be that companies will start purchasing their own ships. However, this scenario is unlikely and is illustrated by the major oil companies who, in modern times, have tried to avoid owning ships due to the great risks associated with it. One example is the oil spill caused by the oil tanker Exxon Valdez, which gave rise to enormous compensation claims. With the future lease standard they will probably continue leasing one way or

another in order to avoid carrying the risk. Stena RoRo further believes that the length of the lease terms will remain unaffected since the lessors want to ensure future cash flows. This is impossible when a contract only runs for one year. Some lease agreements also require the lessor to hire a crew for the ship. This can be inconvenient if the lease contract only lasts for maximum one year. Educating efforts about the new lease standard will be conducted in-house and consultants will only be hired if they can provide value for money.

4.1.3 PREPARATIONS FOR THE NEW LEASE STANDARD

Transatlantic AB: Transatlantic are well aware of the new lease standard but have chosen not to conduct any detailed investigations of what effect it will have on the company. However, the operating lease payments disclosed in the footnotes are examined annually and the company knows roughly with what amount the balance sheet would increase.

AB Volvo: Normally, AB Volvo prepares for changes in IFRS standards by conducting standard calculations to see how key financial ratios will be affected. This has not been conducted to any greater extent regarding the new lease standard. It is largely due to the uncertainty concerning when the new lease standard will be introduced and the effects it might have. Lundquist explains that prior to an implementation of a standard in the European Union, the proposed standard needs to go through an endorsement process conducted by one of the bodies of the European Union, the European Financial Reporting Advisory Group (EFRAG). Moreover, AB Volvo has worked proactively by sending comment letters regarding the exposure draft. The company has also met representatives from IASB to express their views on the topic.

SCA: As a preparation for the introduction of the new lease standard, SCA has issued a survey for all their subsidiaries. In this survey, the subsidiaries were expected to fill in information about what kinds of contracts they are having, which objects they are leasing and what the costs and interest rates for the current lease contracts are. However, because of the uncertainty and the slow progress of the development of the new lease standard, SCA has not conducted further investigations.

Elanders AB: There have not been many preparations for the new lease standard at Elanders. The main reasons are the high degree of uncertainty surrounding the exposure draft and the lack of personnel and time. Contrary to, for instance AB Volvo, which has IFRS specialists working with writing comment letters to the IASB, the employees at Elanders have to keep track on the new lease standard

with the time remaining after their regular tasks. Hence, Elanders will wait and see the reactions of the major companies and try to imitate their moves. Furthermore, information about the new lease standard is frequently provided by Elanders auditors, PwC. Einarsson points out that there will be a couple of years to prepare between the approval of the new standard and its implementation.

Stena RoRo: Some rough calculations with regard to the information presented in the ED have been made. The result showed an increased balance sheet. However, because of the lack of guidelines it is uncertain if the balance sheet will increase. Because of the delays and constant updates, preparations for the new lease standard have been put on hold.

4.2 THE AUDITOR

4.2.1 CONSEQUENCES OF THE NEW LEASE STANDARD

Svärdström explains that companies care about their balance sheets and debt structures. It is no coincidence that some companies, up to this date, have paid extra in consultant fees in order to achieve an operating lease classification. However, with the new lease standard, balance sheets are expected to grow accompanied with changes to the debt structure. As a result, key financial ratios will change. Svärdström explains that many bank credits nowadays are associated with debt covenants, which often are tied to key financial ratios. Hence, it is possible that the new lease standard will require existing covenants to be renegotiated. Moreover, Svärdström explains that key financial ratios can be an important aspect regarding how a company presents itself to the surrounding world. Changes in key financial ratios can therefore be of high importance for some companies. Svärdström explains that she examined the effects on key financial ratios in a company by capitalizing one major lease contract. The findings suggested that the company would receive a worsened operating profit with the new lease standard. In this particular company, the operating profit was the most important key financial metric. Hence, the consequences and their impact will be individual for the companies. Furthermore, she explains that changes in key financial ratios also could have consequences for the companies' strategies. Currently, a lot of companies conduct strategies that e.g. involve having a debt-to-equity ratio higher than X percent. With the new lease standard it is probable that such strategies have to be modified. The administrative burden is also expected to increase since all lease contracts will end up on the balance sheet. At an initial stage this would require a substantial workload. Companies with few lease contracts, independently of value, will find the administrative tasks much easier.

As an auditor, Svärdröm is unable to tell if leasing as a source of financing is expected to change with the new lease standard. However, she believes that it is possible that companies will come up with new lease solutions to obtain the advantageous short-term lease. However, it is questionable if the short-term lease will be used that frequent and especially in volatile industries like the shipping industry. A shipping company offered a beneficial day rate will probably sign a long lease-term agreement rather than a short one, as the risk of not receiving a similar day rate is too great.

Overall, Svärdröm believes the new lease standard will have consequences. Companies that depend on real estate leasing and companies with a lot of lease agreements will be affected the most. However, Svärdröm points out that the companies themselves will not be worse because of deteriorated key financial ratios. They will only be viewed differently in the financial statements.

5. ANALYSIS

In this chapter the findings presented in the previous chapter will be analyzed with the help from the frame of references. The foundation of the analysis is based on the three components of the purpose.

5.1 ANALYSIS OF THE FINDINGS

5.1.1 WHY LEASING IS USED AND HOW LEASE CONTRACTS ARE CLASSIFIED

The findings show that leasing of assets is used when it is economically advantageous compared to purchasing. The most common reason is that leasing is flexible, as the items can be returned once they are not required anymore. The only company that admits that leasing is used to keep assets off the balance sheet is AB Volvo. In certain cases they assert that they only lease property when it is possible to classify as operating. In contradiction to AB Volvo, Elanders and SCA argue that they lease property because it is not part of their core activities. Hence, leasing is used differently among the companies.

As expected and required, all companies follow the guiding criteria in IAS 17 when classifying lease contracts. However, the interesting question is how they interpret the criteria and if they prefer the operating lease to the finance lease. Stena RoRo and AB Volvo are the only companies who explicitly admit that they prefer the operating lease. This is motivated as both Stena RoRo and AB Volvo benefit from such a classification. Elanders also prefers the operating lease but as the contracts are signed locally by subsidiaries, they have little impact of the classification. SCA ignores whether a lease is classified as operating or finance as they believe creditors already take the operating lease into account. Overall, it seems like the companies do not strive for a specific classification. However, the auditor provides an interesting finding as her experience is that companies at times increase their auditing expenses in order to investigate whether an operating lease classification is possible. Furthermore, the auditor argues that companies *do* care about their balance sheet. This statement makes it hard to believe that companies are indifferent when classifying lease contracts.

5.1.2 CONSEQUENCES OF THE NEW LEASE STANDARD

The present study shows that all participating companies expect to have their balance sheets and debt structures increased. This was an expected result as all of them use operating lease. This is also consistent with prior research, which shows that a capitalization of the operating lease would increase

companies' balance sheets and debt structures (Imhoff, et al, 1991; Beattie et al, 1998, Deloitte). Furthermore, the companies report that key financial ratios will be deteriorated, which also is an expected consequence of the new lease standard and supported by prior research (Fülbier et al, 2006; Deloitte, X). However, the interesting question is what underlying effects the deteriorated key financial ratios would have for companies. In this matter, three of the five companies believe that creditors already take the operating lease payments in consideration when evaluating a company's financial position. It is hard to tell how well informed creditors are about the operating lease, but today it is part of the Standard & Poor's *Corporate Ratings Criteria* and therefore ought to be a common knowledge. The new lease standard should therefore not have any greater impact on companies' abilities to receive external financing.

Comment letters sent to the IASB show concern about deteriorated key financial ratios affecting existing debt covenants (ifrs.org [h]). The findings in the present study do not point at effects of this kind. However, it seems as violation of covenants is entirely dependent on how existing covenants are formulated. Elanders is an illustrating example as they do have covenants, but they are tied to interest bearing debt, which means that an increase in the lease liability will have no impact, as it is not interest bearing. Companies with covenants tied to regular debt are likely the ones being affected by the new lease standard.

It was also found that the new lease standard probably will make purchasing more common. However, the items likely being purchased are items of minor value such as coffee machines. This is understandable as every lease contract will be associated with an increased administrative burden, whenever the new lease standard is introduced. Therefore, purchasing will become a more attractive option than it currently is. Overall, the findings in the present study suggest that leasing will remain an important source of financing at all five companies. The fear of leasing vanishing as a source of financing is not supported in the present study.

However, the findings indicate that a changed lease behavior is expected in the future. Transatlantic and AB Volvo admit that it is possible that lease-terms will be shortened to benefit from the short-term lease, as it would hide assets from the balance sheet and ease the administrative burden. Stena AB, on the other hand, needs long-term lease agreements to ensure future cash flows and will therefore not change their lease behavior in the future. The auditor also believes that lease strategies will be reassessed, but probably not in volatile industries like the shipping industry. Also IBM (2012), states that the new lease standard will have consequences on companies leasing strategies.

All companies will face an increased administrative burden. AB Volvo and SCA see this as their main concern regarding the new lease standard. This is understandable as these two large cap companies have a large amount of lease contracts, which have to be handled. This is also supported by O'Donovan (2011) who believes that companies with a large amount of lease agreements are the ones that will have to invest the largest amount of money. Also the auditor shares this view and believes a substantial workload will be required at an initial stage, and especially for lease heavy companies with a lot of lease contracts. A new IT-system will be required at all companies, except Stena that did not comment on the matter. This is also consistent with IBM (2012) who reported that companies will have to purchase a new IT-system to deal with the new lease standard. Furthermore, educational efforts would be required at all companies. However, to what extent remains unclear. Overall, it seems that most the costs associated with the administrative burdens and the IT-systems are transition costs.

5.1.3 PREPARATIONS FOR THE NEW LEASE STANDARD

The findings indicate that the companies not expect to be affected to any greater extent. This might be the reason why the companies have not made many preparations. Also, there is an uncertainty surrounding the new lease standard and its content. This is made evident by the re-exposure, expected in 2012.

The authors conclude that the larger companies, AB Volvo, SCA and Stena RoRo, with a high amount of resources, are the ones who have conducted most investigations concerning the new lease standard. The smaller ones, Elanders and Transatlantic, have not made any preparations at all. Hence, the degree of preparation seems to depend on the size of the companies. What could be questioned is whether it is motivated for companies to prepare for changes that are still in a quite distant future.

5.2 OBSERVATIONS MADE BY THE AUTHORS

Overall, the company respondents were not very well informed about what consequences the companies will face. This became apparent when interviewing the auditor who stated that internal strategies, often including key financial metrics, could be affected. Also O'Donovan (2011) argued that internal control systems might have to be changed because of deteriorated key financial metrics. These effects were not mentioned by any of the companies. One possible explanation is that they did not provide the authors with the whole picture, or that the questionnaire was poorly constructed. If not, the companies will be affected by the new lease standard more than they expect.

6. CONCLUSIONS

This chapter will present the conclusions based on the analysis. In the final part of the chapter, a suggestion for further research will be presented.

The replacement of the current lease standard, IAS 17, removes the possibility for companies to choose between operating leasing and finance leasing. In a future state, all leases will be classified as finance, which implies that the lessee will have to recognize an asset and a liability on its balance sheet. The change of the lease standard is considered necessary to achieve an increased comparability between companies and to reduce abuse of accounting rules. However, the standard setting process has been characterized by disagreements, criticism and delays, which makes it evident that the replacement of IAS 17 is a controversial topic.

The findings in the present study show that the new lease standard will have consequences on companies using operating lease and IFRS. These consequences will include increased balance sheets, changed debt structures, an increased administrative burden, a need to purchase new IT-systems, educational efforts and changes in companies' lease behavior. As a reaction to the increased balance sheet, the key financial ratios will be deteriorated. However, the underlying effects of the affected key financial ratios are highly individual and will be determined by what kinds of agreements the company presently is obligated to fulfill. The results also indicate that companies lease for more reasons than hiding assets from the balance sheet, and leasing as a source of financing will thus remain.

In contradiction to most comment letters received by the IASB, the examined companies do not seem to worry much about the consequences of the new lease standard. This could be due to the non-extraneous opinion that it is not motivated to make preparations when so little is known about the final version of the exposure draft. Regardless, the massive amount of criticism and engagement that the planned change of the lease standard has caused could make one expect companies to be a bit more informed and prepared for the change. However, this study shows that most of the examined companies have not conducted any major preparations about the change. This makes the authors wonder whether the alleged controversy - which has resulted in more than 700 comment letters and a significant delay of the implementation of the new lease standard - is exaggerated.

6.1 SUGGESTION FOR FURTHER REASEARCH

More qualitative research on the consequences of the new lease standard would be beneficial, especially as there will be a re-exposure in 2012. However, interviewing companies was harder than expected as they provided limited information on how they will be affected. Therefore, further qualitative research based on interviews from the perspective of auditors and analysts would be recommended.

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