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> Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH

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Dear Sir David

ED/2010/9 Leases

We welcome the opportunity to provide comments on the proposed amendments to lease accounting, contained in the IASB's Exposure Draft 'Leases' ('the ED') and thank the Board for enabling us to participate in the roundtable.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US\$2,418 billion at 30 June 2010. Headquartered in London, HSBC serves customers worldwide from more than 8,000 offices in 87 countries and territories in six geographical regions. HSBC's businesses encompass a very broad range of financial services and products, including personal financial services, commercial lending, global banking and markets, private banking, asset management and insurance.

HSBC agrees with the Boards that the current leasing standards are inadequate, and supports the efforts of the Boards to develop a new standard together, as part of their commitment to work towards high quality converged international accounting standards.

Right-of-use model and practicality

In principle, HSBC supports the 'right-of-use' concept for lessees. It is a sound principle that obligations under leases should appear on the balance sheet on a consistent basis. However, in applying this concept to all leases regardless of their significance to the business of the reporting entity, HSBC believes that the proposals are likely to be unduly costly and operationally burdensome to implement.

HSBC believes that as a practical matter, a simplified approach is important for both short term leases, and leases of small items ancillary to the main business activities of the reporting entity. HSBC would not support the simplified approach in the ED in its application to small value and ancillary leases, because the method does not significantly relieve the burden of accounting for a large number of individually insignificant items.

Bright lines

We support the elimination of the finance and operating lease distinction and therefore the removal of a bright line as characterised by the use of the '90% test' to classify leases as either finance or operating. The proposed elimination of the operating lease category, however, makes the distinction between leases and service contracts more important. We

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believe that improved guidance on the distinction between the two types of arrangements is required, beyond that included in the ED, which is based on IFRIC 4. We believe that this guidance is likely to be interpreted in a way that results in the new lease accounting model being applied too broadly, capturing many contractual arrangements the purpose of which is to provide services. In general, we are concerned that new 'bright lines' will develop in practice when determining whether the arrangement should be classified as a lease, a 'sale / purchase' contract or a service contract.

Lessor accounting

The proposals add significantly more complexity to lessor accounting as there will be at least six models for lessors (sale / purchase, sale and leaseback, short term lease, lease of investment property held at fair value, derecognition model and performance obligation model) compared with two models today. HSBC does not support the performance obligation approach on both conceptual and practical grounds, and believes that the derecognition approach should form the basis of the standard for lessor accounting, recognising that the approach requires some development to incorporate the accretion in value of the residual asset through time.

Measurement

HSBC believes that further work is needed to simplify the proposals for the measurement of lease payments if they are to be capable of implementation at a reasonable cost. HSBC believes that the proposals for the determination of the lease term that is 'more likely than not' to occur, and the probability weighted assessment of expected cash flows including contingent rentals, would require a level of sophistication in systems and data beyond what is reasonably practicable, and would introduce greater levels of subjectivity into the financial statements that would not be to the benefit of users. It would be possible to simplify the proposals and increase their reliability by retaining the current IAS 17 approach for determining the lease term, and adopting the well understood principle of the best estimate of future cash flows that can be determined with reasonable certainty, consistent with IAS 37.

Transitional provisions

We appreciate that the proposed transitional arrangements provide some practical relief, however, we would like the Boards to consider allowing entities the choice of full retrospective application where information is readily available, in the interests of providing more useful information to users of financial statements where this is practicable.

Regulatory implications

The proposals have potential implications for the measurement of regulatory capital for financial institutions and consideration will need to be given as to how lessees' right-of-use assets will be treated for regulatory purposes, as well as lessors' assets under the proposals. We appreciate that this is a matter for regulatory authorities, however it would be helpful if the Boards would add further explanation of the nature of the assets and liabilities created by the lease contracts, in particular emphasising the similarity of right-of-use assets with items of property, plant and equipment.



Conclusion

In conclusion, HSBC is concerned by the amount of work which it believes is still needed to produce a high quality and operational standard that will provide benefits to the users of financial statements which outweigh the costs of implementation, particularly given the demands placed on the Boards from their own work programme and the convergence timetable. We note that the time remaining to resolve issues and publishing a final standard is extremely limited. We encourage the Boards to take the time to ensure that the finalised proposals are of high quality, that broader impacts have been given due consideration, and that the proposals have been subjected to adequate field testing.

We understand that efforts have been made to consider the costs and benefits of the proposals, for example through the Lease Accounting Working Group. However we do not believe that there has been sufficient consideration of the considerable operational difficulties presented by the proposals. Given the complexity and fundamental nature of the proposed changes, and the fact that the proposals for lessor accounting were first published in this ED, it would have been helpful if the Boards had undertaken further outreach activities to constituents and arranged further field testing, particularly for lessors.

Our responses to the questions set out in the ED are provided in the Appendix. As always, we would be pleased to discuss our comments and concerns in further detail if this would be helpful.

Yours sincerely

Russell Pasi

Appendix: Questions for respondents

Question 1: Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

In principle, we see merit in lessees applying the right-of-use principle to account for the rights and obligations arising from lease contracts. The main benefit of the proposals is to ensure that significant leases of assets used in the production or supply of goods and services are recognised on a consistent basis, as an understanding of the financial effect of these leases is necessary to understand the financial position of the entity. However, the model will be disproportionately costly to implement for short term leases or large numbers of leases of less significant assets whose purpose is ancillary to the main business activity of the entity (for example photocopiers). While in theory it is desirable to account for all leases consistently, the benefits likely to be obtained by the users from applying the approach to short term and ancillary leases is likely to be limited, and it is therefore essential that a practical distinction is drawn. HSBC strongly recommends that a simplified approach is adopted for these short term and small value ancillary leases as the right-of-use model cannot be practically implemented for a large number of small leases without significant resource and system implications.

We propose that a simplified approach for the recognition and measurement of short-term and small value ancillary leases should be similar to the current treatment of operating leases under IAS 17, as further discussed in question 3 below.

In respect of all but the most simple leases, the proposed measurement approach creates additional complexity in measuring right-of-use assets and related liabilities, and we do not think that the measurement principles as currently proposed are workable in practice. Our concerns are discussed in detail in questions 8 to 10 below.

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make payments over the lease term. Our view is that the amortisation of the right-of-use asset should reflect the expected pattern of consumption embodied in the asset and recognise that this might not necessarily always be straight-line; however, we would expect the amortisation to be on a basis consistent with the nature of the underlying asset. In view of the proposal to present the right-of-use asset within property, plant and equipment, we believe that from a conceptual perspective, the proposals would better achieve consistency if, in paragraph 20 of the ED, reference is made to amortisation under IAS 16 instead of the current reference to IAS 38.

Question 2: Lessors

- (a) Do you agree that a lessor should apply
 - (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and

(ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

We believe that the proposed dual model for lessor accounting does not meet a primary objective of this project to simplify lease accounting. From a conceptual and practical perspective, instead of the currently proposed hybrid model, we support the use of the derecognition approach as the single lessor accounting model as we believe it can be applied in all situations and the model is consistent with the right-of-use model for lessee accounting.

We believe that the performance obligation model is not consistent with the lessee right-ofuse approach. The performance obligation model assumes that the lessor still has an obligation to fulfil after the lease has commenced, whilst the lessee recognises a lease liability because the lessor has performed by delivering the asset. The performance obligation model results in a duplication of assets given that both the underlying asset and the related receivable representing expected future cash flows are recognised on balance sheet. In our view the proposed linked presentation of these balances in the statement of financial position with an obligation to provide the asset to the lessee fails to address this shortcoming in the approach, and introduces additional complexity without any improvement in quality and relevance of information.

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

For lessor accounting, the proposed derecognition approach better reflects the economics of the lease contract. However, we believe that the derecognition approach would be better supplemented by a requirement to accrete any residual asset to its fair value at the end of the lease term, as users are interested in understanding the extent of an entity's exposure to residual value risk. We concur with Stephen Cooper's alternative view that failure to remeasure the residual asset understates the profitability of the lessor during the lease term in that it would result in the recognition of a gain on subsequent realisation of the residual asset either through sale, use or re-leasing the asset.

Question 3: Short-term leases

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Adequate relief has been provided to lessors in accounting for short-term leases but this has not been replicated for lessees, where the relief is limited only to the removal of the requirement for discounting when applying the measurement proposals. We believe further simplification should be provided to lessees by requiring short-term leases to be accounted for using the accrual method where the rental cost is recognised as it is incurred, similar to the existing treatment for operating leases under IAS 17.

We would like to see this simplification extended to include small value ancillary leases as this will reduce the administrative burden of applying the extensive measurement proposals to large numbers of insignificant leases, thereby making the proposals far more practicable. Unless the aggregation of such small value and ancillary leases is material to the entity, HSBC recommends that the existing approach in IAS 17 for the recognition and measurement of operating leases be maintained, supplemented by disclosure. If the aggregation of these items is material to an understanding of the financial position of an entity, we accept that balance sheet recognition would be necessary. In these circumstances the simplified approach

in the ED could be used as a cost-effective practical expedient, with the development of a portfolio recognition technique for large numbers of small items of a similar nature.

Where shared services are provided by one wholly owned subsidiary to a number of other wholly owned subsidiaries, as is common for the provision of IT services in large groups, we question the value of the proposed accounting approach compared to the costs of implementation and ongoing accounting procedures. Where these arrangements are for periods of more than one year, we believe that it would be justified on cost/benefit grounds to extend the relief proposed for short-term leases to arrangements between group companies with shared services involving the use of assets.

Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

We have no concerns with the definition, which is similar to the IAS 17 definition. However, in view of the fact that the ED proposes significant changes to lease accounting, we are concerned with the boundaries between leases and other contracts such as sales/purchase contracts and service contracts, which have significantly different accounting treatments. The development of clear distinctions between these various contracts, whilst aligning the proposals with the other IFRS projects, would serve to reduce diversity in practice and reduce the likelihood of new bright lines developing in applying the proposals.

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

We understand that a distinction needs to be drawn between a sale/purchase transaction and a leasing transaction in order to exclude sale/purchase transactions from the scope of lease accounting. Under the proposals in the ED, a purchase or a sale of an underlying asset occurs when an entity transfers "control of the entire underlying asset and all but a trivial amount of the risks and benefits". The 'all but a trivial amount of risks and benefits' criterion is a higher hurdle than the existing 'substantially all risks and rewards' test for identifying finance leases, however we believe that it may be a clearer test to apply in practice.

We note that the proposed criteria are different to those under the revenue recognition proposals, where a sale occurs when control of a good or service has been transferred. However, the revenue recognition proposals clarify that for a purchaser to obtain control of a good it must have the ability to direct the use of, and receive the benefit from, the good. The customer's ability to receive the benefit from an asset refers to its present right to obtain substantially all the potential cash flows from the asset, which could be interpreted to be similar to the 'substantially all risks and rewards' test. We note therefore the potential inconsistency between the two EDs as drafted, and suggest that the Boards add an explanation for this decision to the Basis for Conclusions section.

(c) Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

In proposing a single model for lessee accounting the ED creates substantially different accounting treatments for lease contracts and executory contracts and therefore the distinction between leases and service contracts has become more important. In principle, we agree that leases embedded within service contracts should be accounted for separately as leases in order

to reflect the commercial substance of the arrangements. However, we believe that the guidance currently provided in paragraphs B1-B4 of the ED, which largely appears to have been carried over from IFRIC 4, is likely to be interpreted in a way that results in the new lease accounting model being applied too broadly, capturing many contractual arrangements the purpose of which is to provide services.

We appreciate that this is a complex area and recommend that the Board addresses the issues associated with IFRIC 4. We recommend consideration of the following issues in particular:

- how to determine whether an asset that is a portion of a larger asset represents a 'unit of account', for example, if a lessee rents space in a warehouse, is the unit of account the 'space' rented in the warehouse, or is it only applicable to the whole warehouse?
- identifying the 'specified asset' in a contract, given that this may be either explicitly or implicitly identified in the contract. In practice, this would require all outsourcing contracts to be reviewed particularly for those services that can only be provided through the use of an underlying asset (regardless of whether this is explicitly stated or not). This is a broad scope for the proposals, and increases the operational impact of the new lease accounting approach, bringing within scope, contracts for services that involve the use of underlying assets (incidental or otherwise) irrespective of whether they are significant or not. We believe further consideration should be given to whether such contracts are leases or service contracts by considering:
 - whether the nature of the service provided is one of the provision of output or capacity, and the recipient is economically indifferent to the risks of the underlying asset, and is only interested in whether the output meets the recipient's requirements; or
 - o instances where the underlying assets are typically fungible.
- other operational issues that have caused debate in practice such as how the term 'fixed price' or 'fixed price per unit' applies in practice. We understand that this has been interpreted narrowly to mean a price that is explicitly stated in the contract that is fixed for the entire contract period, whereas a broader interpretation might reasonably consider this to apply in situations where the contract terms explicitly state the price increments applicable over the contract term.

Given the importance of the distinction between service contracts and leases, we believe that the Boards should give appropriate time and consideration to a) describing what is meant by a service arrangement and b) how to account for such arrangements on a basis consistent with the Conceptual Framework.

Scope

Question 5: Scope exclusions

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

In principle, we agree with the scope of the proposed new lease accounting standard which is largely based on the existing accounting standard. However, the elimination of the operating lease category creates significant differences in accounting for leases and service contracts and we would like to see the Boards giving further consideration to service contracts within the context of the leasing project as noted in response to question 4(c) above.

We note that intangibles have not been included within scope of the proposals. Conceptually, we see no reason for this exclusion, particularly as they are currently within scope of IAS 17. In the continued absence of intangibles from the scope of the proposals, consideration must be given as to how leases of intangibles would be accounted for in the interim period from when the lease proposals become effective until the treatment of intangibles is clarified.

Question 6: Contracts that contain service components and lease components

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

In principle, we agree that it is conceptually sound to separately account for service and lease components when contained within the same lease contract as long as these elements are distinct, as defined in the Revenue Recognition proposals.

From the perspective of a lessee, the practical difficulties are increased if the lease and service elements are not distinct. However, we are not convinced that the requirement under these circumstances to treat the whole contract as a lease is the most appropriate accounting outcome, and recommend that each contract be accounted for as either a lease or a service contract depending on which model most closely matches the nature of the contract.

From the lessor's perspective the lease and service elements should normally be separately identifiable. We disagree with the performance obligation approach under any circumstances.

Question 7: Purchase options

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We are concerned that the Boards are proposing different approaches to accounting for options. After inception of the lease, purchase options are only accounted for when exercised, however renewal options are considered in the initial and subsequent measurement of lease payments. Furthermore, in the Revenue Recognition project, purchase options are considered in determining the transaction price, which is also inconsistent with these proposals. A consistent approach to accounting for all options would reduce the likelihood of developing new bright lines in lease accounting and our preference is for the proposals to increase the recognition threshold for all options so that they are recognised only when it is reasonably certain that they will be exercised.

Measurement

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not see any conceptual or practical reason for changing the lease term as currently determined using the 'minimum lease term' concept in IAS 17 and therefore, do not support the Board's rationale for determining the lease term based on the 'longest possible term that is more likely than not to occur' notion because we do not believe that this will yield improved

information for users. In most instances, determining the lease term including renewal option periods that the lessee has the choice not to exercise will give rise to liabilities that are not consistent with the Conceptual Framework. Further, applying the 'more likely than not' concept in this context to lease terms is likely to be unduly complex in practice. This represents a fundamental shift to a more behavioural basis of accounting. We are concerned that this concept would not be consistently applied by preparers, and question the value of the information it would provide to users. Raising the threshold for the recognition of options to extend or terminate leases to 'highly probable' or 'reasonably certain' would mitigate this concern and also provide practical relief through, for example, reducing the need for frequent reassessments.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

We have previously disagreed with the Boards' proposed use of the expected value approach in other projects including Liabilities, Revenue Recognition and Impairment. We acknowledge that the concept has some theoretical merit, but we believe that it is only likely to produce reliable measurements for financial reporting purposes in the case of homogeneous and high volume transactions or balances, where there are large enough statistical populations to be able to reach sound conclusions. We believe that the application of such a principle to leases or other separately negotiated contracts with unique features would, in most instances, be unduly burdensome and not yield reliable or meaningful information. Requiring entities to measure lease assets and liabilities based on intentions or expectations without the existence of sufficiently sound evidence increases the susceptibility of the financial statements to accounting risk. There is also the prospect of earnings management through the use of assumptions that, while supportable, may prove over optimistic with the benefit of hindsight. Furthermore, developing expectations of events that could take place in the future, especially when the terms are greater than three or five years and therefore beyond the scope of typical business horizons, is not likely to yield reliable results. We would therefore prefer the lease payments to be based on the well understood notions of 'minimum lease payments' as required by the current IAS 17, and the 'best estimate' of cash flows required to settle obligations, as in IAS 37.

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

We do not see how contingent rental and expected payments meet the definition of a liability since they cannot be contractually or constructively enforced and therefore support Stephen Cooper's alternative view in this regard. In our view, the recognition of amounts that can be reliably measured is not a sufficient safeguard and we therefore support a higher threshold for the recognition of contingent rentals, residual value guarantees or early termination penalties such as the current threshold in IAS 17 where such uncertain amounts are only considered when it is 'reasonably certain' that they will be exercised.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We believe that the requirement to determine whether there has been a significant change in the liability to make lease payments or in the asset representing the right to receive lease payments is unduly onerous because of the extensive and complex measurement proposals in the ED. For the assessment to be practicable, we recommend that the proposals for determining the lease term are simplified and the threshold for recognising contingent payments should be increased as noted in our responses to questions 8 and 9 above. If the Boards were to retain the current proposals, it would be generally impracticable to carry out such assessment on a contract-by-contract basis and we would therefore wish to see the further development of proposals to allow assessments to be carried out on a portfolio basis.

Sale and leaseback

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We understand the need for additional guidance on sale and leaseback transactions, but believe that the proposals would be improved with a principle requiring entities to consider the commercial substance of arrangements to determine whether transactions are linked. We consider that most of the additional conditions in B31 are consistent with the notion that a sale should involve transferring 'all but a trivial amount of risks and benefits' in the asset. We are concerned that some of the conditions have been very strongly worded, however, particularly condition (j), so that they may capture certain protective clauses which are not intended to confer ownership rights on the seller.

Presentation

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

We agree that lease assets and liabilities should be presented separately from other assets and liabilities as proposed in the ED but believe there should be a choice of presenting this information either on the face of the statement of financial position or in the notes. We welcome the right-of-use asset being presented as a tangible asset. In view of this we would expect the amortisation (depreciation) method to be determined in accordance with IAS 16.

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We do not support the performance obligation approach for lessors and therefore have not commented on the presentation proposals relating to this approach as we believe it is conceptually flawed.

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We agree with the proposed presentation requirements in the ED for lessors applying the derecognition approach, however, we would prefer entities to have a choice of presenting the information either in the statement of financial position or in the notes depending on the significance of such information to the entity.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

We agree with the proposed presentation requirements for subleases. We would prefer entities to have a choice of presenting the information either in the statement of financial position or in the notes depending on the significance of such information to the entity.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We think that separate presentation of lease income and lease expense is important where such items are material. We would prefer entities to have a choice of presenting the information either in the income statement or in the notes depending on the significance of such information to the entity.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We think that separate presentation of cash flows from leases is important where such items are material. We would prefer entities to have a choice of presenting the information either in the statement of cash flows or in the notes depending on the significance of such information to the entity.

Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We agree with the disclosure principles as set out above, and support the Boards' clarification in paragraph 71 which would ease the disclosure burden as it allows for the aggregation of disclosures where necessary to satisfy the disclosure requirements.

Transition

Question 16

- (a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

The proposed transitional arrangements provide some practical relief, but we believe that the interests of users would be better served by permitting full retrospective application where the information is readily available, on a lease by lease basis. We are concerned that treating all leases essentially as 'new' leases on transition will distort the income statement to the extent that the right-of-use approach will generate amortisation (depreciation) and interest costs greater than rental charges in the early part of a lease. We welcome the alternative view expressed by Stephen Cooper that "the proposed transitional provisions could be amended so that the right-of-use asset is not set equal to the transition liability, but instead takes into account the impact of the remaining lease term compared with the original lease period."

We believe the Board should also consider grandfathering the existing accounting for transactions, particularly where the information necessary to achieve transition to the new requirements is not readily available. In this instance, the proposals would be applied to any new leasing contracts entered into following the date of initial application, and existing contracts at that date where the information is available.

We believe it would be appropriate to provide additional relief on transition by extending the short-term lease accounting proposals to leases which, on adoption date, have a remaining period of less than one year.

Benefits and costs

Question 17

Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

The sophisticated system changes required to accommodate the measurement proposals will translate into significant one-off expenses coupled with ongoing costs for resources required to carry out the periodic assessments. Therefore, the proposals as currently exposed will add a significant cost for lessors and lessees. Furthermore, this cost will be disproportionate in effect compared to the benefit to users when applied to small ticket transactions. We remain to be convinced that the benefits of enhanced transparency justify the proposed changes. Furthermore, these proposals appear likely to be introduced at the same time as other projects that would require significant systems changes, for example Financial Instruments (Classification and Measurement), Impairment, Revenue Recognition, and Insurance. As a result, we encourage the Boards to balance the objectives of the project with the operational concerns to create a standard that is workable in practice.

Other comments

Question 18

Do you have any other comments on the proposals?

The proposals have potential implications for the measurement of regulatory capital for financial institutions and consideration will need to be given as to how the lessee's right-of-use assets will be treated for regulatory purposes. We appreciate that this is a matter for regulatory authorities, however it would be helpful if the Boards would add further explanation of the nature of the assets and liabilities created by the lease contracts. HSBC regards the right-of-use asset as similar in nature to a fixed asset albeit with a time limitation and therefore believes that this asset should be classified within property, plant and equipment.

Likewise, the proposals could have a bearing on the way that tax authorities treat lease arrangements for tax purposes. We understand that this is a matter for tax authorities but would like to highlight the potential implications as they could have commercial impacts on the economic viability of lease arrangements, and recommend that sufficient time should be allowed for the relevant parties to understand the nature of any impacts.

We would like the proposals to provide explicit guidance on how to account for lease incentives which would arise in some contracts such as free rent and funding allowances for tenant improvements, a topic which is not included in the ED as currently drafted.