1850-100
Comment Letter No. 394

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

15 December 2010

Dear Sir David,

Exposure Draft ED/2010/9
Leases

Standard Chartered PLC (the Group) is an international banking group listed on the London, Hong Kong and Bombay stock exchanges. It operates in more than 70 countries, principally in Asia, Africa and the Middle East.

We welcome the opportunity to comment on the above exposure draft (ED) and our detailed responses to the questions are set out in the attached Appendix.

Whilst we conceptually agree that leases entered into by lessees should result in the recognition of a liability on the balance sheet, we believe that the model proposed by the Board would result in the recognition of assets and liabilities that in certain circumstances would not appear to meet the definitions as set out in the Conceptual Framework.

Furthermore, for those leases with optionality, the proposals would inject a significant degree of management judgement in determining the lease term which results in an unnecessary degree of complexity. We question whether the lease liability created under these proposals is itself in conflict with the Conceptual Framework as the renewal options do not create an irrevocable liability regardless of expectation. We are therefore supportive of the "Alternative View" set out in the ED.

We are also concerned at the potential for significant divergence between the assets and liabilities recorded by the lessee and those recorded by the lessor as a result of differing assessments of lease terms and discount rates. We consider that the lessor should apply a mirror treatment to the lessee in all cases. Applying the performance obligation approach unnecessarily grosses up the assets on the balance sheet and artificially inflates the balance sheet and we therefore favour the application of the derecognition option in all cases.

The Board articulates that, amongst other factors, the proposals have been developed to meet the needs of investors. However we question whether the proposals developed are in line with the expectations of the investor community, in particular the divergence of the relationship between the actual cash flows – the rental payments – and the amounts recorded in the income statement. Changing the nature and composition of lease payments in the income statement may confuse more than enhance users' understanding of the financial statements.

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In assessing the cost/benefits of the proposals, we believe that there are a number of ancillary costs that the Board should take into consideration – including the impact on existing lease covenants, the need for tax legislation to be amended in a number of jurisdictions, and for financial institutions the impact on capital and other prudential ratios and (where applicable) levies determined on outstanding liabilities – in addition to the additional operational and system costs required to operationalise the proposals. We believe that the potential costs of implementing these proposals could outweigh the benefits accruing to the users of the accounts.

We would urge the Board to reconsider those elements of the proposals that appear to be in conflict with the Framework and to solicit more detailed views from the user community before finalising the proposals, to ensure that the Standard that replaces IAS 17 represents an improvement in financial reporting and that it is conceptually consistent. We recognise that this may not be aligned to the Board's June 2011 timetable although we note that in the interim many of the concerns of users of the financial statements could be addressed by enhanced disclosures.

We would be pleased to provide any additional information or clarification of our comments if you so wish.

Yours sincerely,

Chris Innes-Wilson
Head, Group Accounting Policy & Advisory

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Appendix

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?

Whilst we conceptually agree with the recognition of a liability for lease contracts, we do not believe that the proposals recommended by the Board would enhance the ability of users to understand the financial statements. This is due to a number of factors:

(a) **Increased complexity** – the replacement of straight-line recognition of rental expense with amortisation and interest expense means that the amounts recognised in the income statement can no longer be appropriately related to the underlying economic cash flows related to the lease and therefore may confuse rather than improve user understanding.
(b) **Increased management judgement** – the proposals would introduce a significant element of management judgement and subjectivity into the determination of the appropriate lease term for lessees and lessors and in determining the discount rate for lessors. We do not concur with the Boards' reasoning in paragraph BC6(d) that the assets and liabilities determined under these proposals are aligned to the definitions in the Conceptual Framework 2010. Paragraph 4.15 of the Framework states that "an essential characteristic of a liability is that the entity has a present obligation" whilst paragraph 4.16 draws out the fact that "a distinction needs to be drawn between a present obligation and a future commitment. An obligation normally arises only when…the entity enters into an irrevocable agreement..". The Board's proposals for requiring the recognition of renewal options in determining the liability appears to contradict the 'irrevocable' nature of a liability – the entity can avoid the liability by not renewing. Whether the entity does so or not is controlled by the entity and it is not appropriate to consider economic compulsion as the basis of recognising the liability.
(c) **Lack of symmetry** - we are concerned that lessors and lessees could determine different lease assets and liabilities by virtue of differing management assessments of expected lease terms and discount rates.
(d) **Costs of fulfilment appear to far outweigh any potential benefits** – we consider that the cost of collating information on all leases, including those that are not 'core' to the business, together with the requirement to constantly review would outweigh any potential benefits that may accrue to the users. For those leases that are not core to the underlying business – such as those relating to operational items (photocopiers, cars) – we consider that enhanced disclosure would be more appropriate than on-balance sheet recognition.

For financial institutions this will also increase the amount of capital required to be held, reducing the capacity of banks to lend to customers and will result in a real economic cost to financial institutions and to economies overall. In certain circumstances, where intercompany leasing arrangements are in place, this could significantly increase the level of capital required to be held across the Group.

(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?

The principles of amortisation and unwinding the discount related to the liability are inherent in the types of assets and liabilities that are recognised as part of these proposals. We do not believe that replacing rental expense in the income statement with interest and amortisation would represent more useful information to users – in this regard, we believe that the users are interested in cash flows and future cash flow exposure rather than the notional balance sheet and income statement flows that the proposals would generate.

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?

(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?

We disagree with the Board's proposals to have two accounting models for lessors and we believe that lessors should apply accounting that mirrors the amounts recognised by the lessee. Consequently, we consider the derecognition model to be the most appropriate model to apply. We do not consider the "performance obligation" approach to be appropriate as this, in our view, incorrectly grosses up the balance sheet, inflating gross assets as the lessor will have two assets (the leased item and the rental receivable) whilst the lessee will also recognise one asset (the "right-of-use" asset). In addition, a liability is recorded in relation to the leased asset, when in reality there is no additional leverage taken on by the lessor in the lease arrangement.

We consider partial derecognition of the asset to be appropriate as this better reflects the fact that the lessor has relinquished the ability to use that asset for a period of time and has given up the economic benefits to be earned from that asset in exchange for rental payments. Consequently, we believe that the performance obligation approach does not correctly reflect the economic reality of the leasing arrangement.

We are also concerned that the discount rate used by lessors may differ markedly from that used by lessees. Lessees are required to discount based on their incremental borrowing rate or (if available) the rate the lessor charges the lessee. Lessors are required to use the rate the lessor charges the lessee which may be one of several rates – the lessee's incremental borrowing rate, the rate implicit in the lease, or property yields where appropriate. This provides significant scope for lessors in determining their balance sheet values. We believe that lessee and lessor rates should be aligned as far as practicable.

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Question 3: Short-term leases
(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

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?

We agree that the final proposals should include a practical and pragmatic approach to the recognition of short-term leases although we consider that the approach should be the same for lessors and lessees. The proposals in the ED only provides limited relief to lessees by avoiding the need to discount – especially as discounting is usually not undertaken in circumstances where it would not be material. In addition, whilst the same expense is recognised in the income statement as under IAS 17, rental expense would be re-characterised as amortisation which has the potential to confuse investors. We would propose that the requirements of paragraph 65 relating to lessors are applied for both lessees and lessors, which essentially follows the existing requirements of IAS 17, and should be applied to all short-term leases rather than on an elective lease by lease basis.

We would note that the ED offers contradictory arguments in respect of short-term leases, noting in BC43 that “short-term leases could give rise to material assets and liabilities” whilst in BC45 stating that “the short lease period may make their [the estimations and calculations proposed for other leases] impact on the financial statements insignificant”.

Question 4: Definition of a lease
(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

Although the requirements in the ED are consistent with those in IAS 17, we consider that more clarity is required in the identification of the lease and service components. In addition, we believe that the definition should include reference to the fact that whilst there is a conveyed right to use the leased asset, the title does not have to transfer in order for it to be recognised. We also note that “period of time” is not clearly defined and should be linked to the lease term.

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(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 are concerned that the criteria appear to be inconsistent with the Revenue Recognition proposals in that the criteria mixes aspects of control – which forms the cornerstone of the Revenue Recognition proposals – and risk and rewards in determining whether a sale is recognised. We believe that the determination of a sale transaction under the leasing proposals should be in line with the Revenue Recognition proposals - that is, there should be one model applied for revenue recognition.

In respect of the criteria presented in the ED, certain aspects of the definitions require more clarification. For example, we note that the definition in B9 distinguishes between leases and purchases by assessing whether "all but a trivial amount" of the risks and benefits have been retained – we are unclear to what degree an amount may be considered "trivial" and whilst we accept that management judgement is required we consider that this may lead to a lack of comparability. We would also note that the use of "trivial" in this context is inconsistent with the assessment of whether the customer has a "right to obtain substantially all of the potential cash flows" as required under the Revenue Recognition proposals

(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?

Although the lease definition is clear, we believe that more guidance and clarity is required around the delineation of service contracts.

Question 5: Scope exclusions
The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

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?

We agree with the proposed scope and we note the Board's intention to consider the accounting for intangible assets more broadly.

Question 6: Contracts that contain service components and lease components
The exposure draft proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

> **(i) a lessee should apply the lease accounting requirements to the combined contract.**
> **(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.**
> **(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in *Revenue from Contracts with Customers*.**

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?

On the basis that lessor should apply the derecognition approach, we believe option b(iii) is appropriate for lessors although if the service component is not distinct (which we do not expect to be common) we question whether the service component can be appropriately identified in order to appropriately account under the Revenue Recognition proposals.

Question 7: Purchase options
The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64). 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 agree that purchase options should only be accounted when they are exercised although we note in our response to question 8 our concerns in general about the inclusion of options in determining the value of assets and liabilities.

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 disagree with the proposal. This would result in a significant degree of management judgement being applied and as discussed in our response to question 1, we question whether the proposals in respect of extension options would result in assets/liabilities that are consistent with the Conceptual Framework. In addition, we note that this may cause a significant disparity between the lessee's liabilities and the asset recognised by the lessor. We are supportive of the views set out in AV2 – AV4.

In terms of the proposals, we are also concerned as to how the "longest possible term" is derived, as it appears to be neither management's best estimate nor a probability-weighted approach, but a new variant. The Board should be consistent in its use of assessing uncertainty in determining assets and liabilities and we urge the Board to clarify that the approach should be based on management's best estimate and not utilising probability-weightings.

If the Board persists with including an assessment of extension options in determining the liability, it would be more reasonable to continue the requirements of IAS 17 in this regard such that the lease term represents the non-cancellable period and any further terms for which it is reasonably certain the lessee will exercise an option to extend, reflecting management's best estimate.

However, whilst the above approach worked under the "off-balance sheet" accounting of IAS 17, as the proposals now require the recognition of liabilities, those liabilities should be determined on a basis consistent with the Framework. We believe that a more appropriate approach (for lessees and lessors) would be to determine the assets and liabilities based on the minimum lease term, with supplementary disclosure in respect of the existence of extension options and the likely impact of taking up those options.

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?

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 agree that contingent rentals be included and the basis for their inclusion should be the same for both lessees and lessors, although we note that this may result in assets and liabilities not meeting the definitions set out in the Conceptual Framework and as discussed in paragraph AV7-AV8. However, we believe that such amounts should only be included where they can be measured reliably – for both lessors and lessees – as their inclusion would avoid structuring opportunities.

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Generally we would expect contingent rentals based on indices to be more reliably measurable than those dependent on management forecasts and we therefore have sympathy with the view in AV6 around the impact on reliability as a result inclusion of those contingent rental payments based on future business performance.

In determining the rentals to be included, consistent with our response to question 8, we believe that uncertainty should be addressed by utilising management's best estimates of cash flows rather than determining amounts using a probability-weighted approach as this will provide more reliable, relevant and less volatile information.

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 do not support the proposal as we consider that the requirement to reassess assets and liabilities will be unduly onerous, especially under the Board's preferred "expected outcome" approach. This is exacerbated where an entity has a large number of low value non-core leases. In order to determine when there is a "significant change" in the liability, entities will have to compute the impact of any changes in order to make such a determination. In addition, given the subjective nature of some of the assumptions underpinning the assets and liabilities, it is unclear how the proposals could reasonably be enforced. The interpretation of "significant change" in itself is judgemental and may lead to inconsistent application in practise. One alternative could be to require reassessment using factors similar to those used when assessing impairment.

Question 11: Sale and leaseback
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 agree with the criteria proposed although we note our response to question 4(b) in respect of our concerns with the delineation between a sale/purchase and a lease. We do not agree with the approach outline in paragraph 67(b) which requires the continued recognition of the asset transferred; as set out in question 2, we believe a 'partial derecognition' approach is more appropriate.

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?

(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?

In respect of questions 12 – 14 we believe the Board should consider any detailed changes in disclosure and presentation in more depth as part of their ongoing project on Financial Statement Presentation.

We do not believe that it is appropriate to disclose these assets and liabilities as separate line items in the financial statements unless the amounts are significant. We believe that is more appropriate to make these distinctions and disclosures in the notes to the financial statements for both lessees and lessors. Accordingly, for lessors we do not consider that a linked presentation approach should be reflected on the face of the balance sheet but should instead be summarised in the notes.

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?

As noted in our response to question 12, notwithstanding our comment in respect of the Board's Financial Statement Presentation project, we believe additional analysis should be disclosed in the notes unless the amounts are significant.

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?

As noted in our response to question12, notwithstanding our comment in respect of the Board's Financial Statement Presentation project, we believe additional analysis should be disclosed in the notes unless the amounts are significant.

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 proposals that lessees and lessors disclose the basis on which the underlying assets and liabilities have been determined. As noted in our response to question 8, we believe that it is more appropriate to reflect the existence and impact of renewal options through enhanced disclosure rather than compromising the definitions in the Conceptual Framework. We would also note that the disclosures should be sufficiently aggregated to avoid compromising commercial negotiations between lessees and lessors.

Transition
Question 16
(a) The exposure draft proposes that lessees and lessors should recognize 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?

Whilst we support and recognise the benefits of the proposed transition requirements, we are concerned that this approach would reduce lessee profits following adoption in a way that is not aligned to the underlying economics and would propose that this either be supplemented by additional disclosure and/or by the incorporation of the option to apply the proposals on a fully retrospective basis. Although a full retrospective approach would be more onerous, where prepares have the information available to apply this it would enable them to reflect a more appropriate representation of the economic reality. We recognise the introduction of a choice may reduce comparability. However we believe that the transitional disclosures could be enhanced to address this and to provide more detail on the impact of applying the simplified retrospective approach.

In applying full retrospective approach we note that clarification of how assumptions should be made at the date of adoption will be required. For example, should assumptions concerning the most probable lease term be made based on what the reporting entity would have assumed at the inception of the lease or what the assumption is as of the date of adoption of the new standard.

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?

We do not believe that the costs of implementing the proposals are in line with the perceived benefits. The proposals would incur significant cost in collating and maintaining a database of leases, in establishing the expected lease term where optionality exists, and in the continual reassessment of the lease liability over the lease term. We consider that the aim of the proposals was to provide better information to users of the accounts about the extent to which entities were relying on off-balance sheet financing so that such liabilities could be factored in when assessing lending decisions and to assist in cash flow prediction. We consider that, for lessees, the proposals achieve neither of these aims, creating an artificial asset, a liability that incorporates amounts for which there is no present obligation and income statement amounts that are unrelated to the cash flows.

The proposals could also have a significant knock-on impact in other areas, not least of all taxation in a number of jurisdictions, some of which may opt to continue with IAS 17 when drawing up tax accounts. For financial institutions, capital may be impacted and costs would increases in those jurisdictions with liability-led levies. Across the broader economy, it is not clear how the change would impact existing banking covenants and any resultant breaches that may occur because of the change in accounting – even though there has been no change economically.