



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

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30 Cannon Street
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Exposure Draft – Leases

Dear Sir David

The Committee welcomes the opportunity to comment on the International Accounting Standards Board's Exposure Draft (ED) on *Leases*. The Committee agrees with the broad direction of the project. When the ED is appropriately applied it would encourage transparency, and would reflect an improvement to current lessee accounting for operating leases, in particular, as all assets and liabilities relating to the business activities of the entity would be presented on the balance sheet. However, the Committee believes that there will be challenges with applying this ED in its current form. These challenges are discussed below. The Committee also encourages both the IASB and US Financial Accounting Standards Board to continue developing a single set of high quality converged lease accounting requirements as this would be beneficial to investors and users across the globe.

The Committee recognises that this proposal may have certain implications for regulatory capital. While the Committee continues to analyse these implications in greater detail, it supports the proposed presentation of the lessee's right-of-use asset being part of property, plant and equipment for financial reporting purposes. This is because that right-of-use asset is tied to a physical asset that generates value in use¹ and is consistent with a lessee's current balance sheet presentation of leased assets for finance leases under IAS 17 *Leases*.

The Committee would like to draw the IASB's attention to the fact that the ED may result in significant changes to existing business models for certain banks in some jurisdictions that actively engage in leasing transactions. These banks operate as lessors in some leasing transactions and as lessees in other transactions. Careful attention needs to be given to the transitional accounting measures and the timing of introduction to allow banks to evolve to this new leasing accounting model.²

¹ Paragraphs BC 143 and BC 144 of the Basis for Conclusions accompanying the ED supports this line of reasoning. Classification of the right-of-use asset as part of Property Plant and Equipment "provides useful information about the productive capacity of a business."

² The Committee will be commenting separately on the IASB's Request for Views on *Effective Dates and Transition Methods*.

This would avoid any unintended financial stability consequences arising from the adoption of the new standard.

The Committee understands that the IASB believes that the proposed derecognition model for lessor accounting is more closely aligned with a bank's business model as a financier in leasing transactions and is a result of the IASB's extensive outreach activity. Proposing different models depending on whether or not there is a transfer of significant risk and benefits for lessor accounting could increase subjectivity. If the standard is applied inconsistently, this might reduce comparability between entities, or permit accounting policies that do not reflect the economic substance of leasing transactions. The Committee would encourage the IASB and FASB to work together to reduce operational complexity when adopting the new requirements for lessors. In order to ensure that the accounting approaches are applied as intended, preparers and others would benefit if the application guidance in paragraphs B22-B27 were supplemented with examples.

The Committee also has specific comments on some of the requirements in the ED. These comments are set out below.

Specific Comments

- *Operational complexity in measurement requirements* – The ED's measurement requirements for lease transactions are likely to introduce significant operational challenges. These operational challenges stem from the complexity relating to the determination of the present value of lease payments and the subsequent re-measurement requirements for lessors and lessees. The complexity associated with these measurement requirements for leases are further explained in paragraphs (a) and (b) below.
 - (a) *Present value of lease payments* – The initial and subsequent measurement of the present value of lease payments by both lessees and lessors (under both proposed approaches) requires the determination of a probability-weighted average of the cash flows for a reasonable number of outcomes. The cash flows must include estimates of contingent rentals payable and payments under term option penalties and residual value guarantees. Requiring probability-weighted averages adds unnecessary complexity (and cost) to the proposed standard, particularly for small financial institutions and other small entities. The Committee considers it unlikely that the probability-weighted outcome will yield significantly more decision-useful information for financial statement users than a present value derived from a best estimate of the cash flows (without probability-weightings). Moreover, the ED requires reassessments after the commencement of the lease when facts and circumstances indicate a significant change in the carrying amount of the lessee's lease liability or the lessor's lease receivable. The reassessments would be supported by disclosures about significant assumptions and judgements relating to the inputs used in the present value calculations and changes therein. These provisions of the standard would ensure there is sufficient rigour when using a best estimate of the cash flows and would support a change from the required use of probability-weighted averages. The

Committee, therefore, recommends that the IASB revise the proposed present value provisions of paragraphs 14, 35 and 52 to incorporate the use of the best estimate of cash flows.

- (b) *Lessor's and lessee's subsequent re-measurement requirements (and related disclosures)* – The ED requires both lessors and lessees to take into account contingent features and optional lease periods. There is a need for more application guidance when applying the estimates used in the model and when making decisions about contingent rentals to ensure faithful representation, transparency and comparability across lease transactions. This is irrespective of whether a probability-weighted average of cash flows or a best estimate of cash flows approach is adopted. These contingent features and optional lease periods need to be determined on a realistic basis by both lessors and lessees. The Committee recognises that when contingent features and optional lease periods are taken into account, these do not need to be reconcilable as between the two sides of the transaction, because lessors and lessees may work off different information sets.

The Committee believes that transparent presentation and disclosures are also needed by lessors and lessees to ensure the standard is applied as intended. That is, the disclosures should allow users to compare and make judgements about the assumptions and terms and conditions used by lessors and lessees for similar sets of lease transactions in an objective manner.

- *Short-term leases* – The ED proposes a simplified measurement method for short-term leases (one-year leases). The requirements include gross presentation with no discounting for lessees, and accrual accounting for lessors. This simplified treatment is welcomed, but it is based on a period of one year which in practice does not provide significant relief for lessees. The Committee encourages the IASB to consider whether further practical expedients for short term leases could be included in the standard. Instead of prescribing a one-year cut-off for short-term leases, an alternative could be to develop principles-based guidance that allows a simplified treatment when the effect of applying the alternative on the balance sheets of lessors and lessees is not material.³ Such an approach would enable banks and other entities that are lessees of assets with individually minimal costs and short useful lives,⁴ such as cars, photocopiers, and telephone and information technology equipment (eg personal computers), to avoid incurring the significant additional costs of applying the ED's measurement requirements to these leases. The disclosure requirement in paragraph 75 would need to be modified to reflect this principles-based guidance. The Committee also recommends that lessors that apply this simplified measurement approach should disclose the amount recognised in the balance sheet for the underlying assets subject to these leases.

³ Materiality could be defined as in IAS 1 *Presentation of Financial Statements*.

⁴ At present, assets with these characteristics are typically accounted for as operating leases.

- *Measurement of the lessee's right-of-use asset* – The ED allows the lessee to revalue the right-of-use asset for each class of property, plant and equipment to which the underlying asset belongs. However, this re-measurement approach is inconsistent with the re-measurement approach by which property, plant and equipment in non-leasing transactions are currently accounted for under US generally accepted accounting principles, especially in regards to the recognition of possible increases in value. We recommend that the IASB reconsider this aspect of the proposal to ensure that there is a consistent measurement principle applied for lessees' right-of-use in order to enable a converged standard. If immediate convergence is not possible on this aspect of the standard, we recommend that the IASB and the FASB observe the resulting differences on the balance sheets of relevant companies and establish an appropriately prioritised effort to eliminate this difference in the future.

Moreover, when measuring the lease liability at the present value of the lease payments, paragraph 12(a) of the ED states that the lessee can use either of two rates: the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee. Although we understand that the IASB has proposed this treatment in order to address concerns expressed on the 2009 *Leasing: Preliminary Views Discussion Paper* that proposed only the incremental borrowing rate, the choice of discount rate can be made on a contract-by-contract basis to achieve a desired outcome. Further guidance might be appropriate to ensure that this choice is applied as intended in practice.

- *Sale and leaseback transactions* – The Committee emphasises the importance of the IASB's anti-abuse provisions in paragraph B31 of the ED. These provisions need to ensure that participants in sale and leaseback transactions do not recognise upfront gains in profit or loss unless these gains have been genuinely achieved. The IASB could further evaluate these anti-abuse provisions before finalising the standard to ensure that these provisions would operate as intended.

We trust you find these comments helpful.

These comments have been prepared by the Committee's Accounting Task Force (ATF), chaired by Sylvie Mathérat, Director of the Banque de France, based on the work of the ATF's Financial Instruments Practices Subgroup. If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579) or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely



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