



## The Stock Exchange of Hong Kong Ltd.

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30 November 2010

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Mr. Steve Ong  
Director, Standard Setting  
Hong Kong Institute of Certified Public Accountants  
37/F., Wu Chung House  
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Wanchai, Hong Kong

Dear Steve,

### IASB Exposure Draft on Leases ("Exposure Draft")

I refer to your letters dated 16 September 2010 on the above Exposure Draft to our Mr. Charles Li and Mr. Mark Dickens which have been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out below.

#### General

The Exposure Draft sets out fundamental changes to lease accounting for both lessees and lessors. The proposals are intended to reduce complexity and improve consistency in accounting for leases. The Exposure Draft proposes a new single "right-of-use" model for lease accounting. Under the proposals, lessees will be required to recognise assets and liabilities arising from all leases in their balance sheet.

Although we agree with the objective of promoting greater consistency in accounting practice, we believe the proposals will add unwarranted cost to preparers and will also add complexity to financial statements and as a result make them less understandable and useful to readers. We have significant concerns that the proposals are inconsistent with the current Conceptual Framework. Before the Board proceeds with the proposals, we believe it should seriously re-consider the conceptual aspects of the proposals and the impact they may have on the future accounting for other service contracts and commitments. Our detailed comments are discussed further below.

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### Conceptual basis for recognising “right-of-use” assets and liabilities

Under the proposals, a lessee will be required to recognise in its balance sheet a “right-of-use” asset and also a liability to make future lease payments from the commencement date of a lease. This approach is substantially different to that currently required under IAS 17 which requires a lessee to account for the leased asset either by recognising an asset and a liability (“finance leases”) or recognising regular lease payments as they are made (“operating leases”), depending on whether there has been a transfer of substantial “risks and rewards” of ownership of the asset. Currently, future payments under “operating leases” are disclosed in the notes to the financial statements to indicate the timing of actual future cash outflows.

To support the proposed treatment, the Board has attempted to explain that the proposals are within the Conceptual Framework. Paragraph BC6(d) of the Exposure Draft explains that the “right-of-use” model *“would be consistent with the boards’ conceptual frameworks. A right-of-use asset is a resource controlled by the lessee as a result of entering into the lease (a past event) and from which future economic benefits are expected to flow to the lessee. It therefore meets the definition of an asset. An obligation to make lease payments is a present obligation of the lessee arising from entering the lease, the settlement of which is expected to result in an outflow from the lessee of resources embodying economic benefits. It therefore meets the definition of a liability”*.

Paragraph BC7(b) further states that *“in the boards’ view, a simple lease is not an executory contract after the date of commencement of the lease. When the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset and therefore an unconditional liability to make lease payments. At that point the lessor cannot prevent the lessee from using the underlying asset nor can the lessee avoid payment without causing a breach of contract”*.

We are not convinced by the above arguments which we believe do not fully and properly address the following fundamental conceptual issues as discussed in our letter to you dated 3 July 2009 on the discussion paper on “Preliminary Views on Leases”:-

- (a) Is a “right-of-use” an asset?

The current Conceptual Framework defines an “asset” as *“a resource controlled by the entity arising from past events and from which future economic benefits are expected to flow to the entity”*. We believe the essential characteristic of an asset is that its holder must possess the “risks” and “rewards” of ownership and this is usually accompanied by control over the item. “Control” per se is insufficient if it also does not include the rights and benefits of ownership.



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We would draw your attention to paragraph 58 of the Framework (1997) [temporarily renumbered as paragraph 4.13 in the 2010 version] which states that “*Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset*”. This indicates that future transactions and events do not give rise to assets. However, the proposals will require a lessee to estimate and recognise its intentions and an asset at the inception of a lease.

We believe that for an asset to be recognised, the “holder” should have no restrictions on how he may make use of the item. In the case of an operating lease we believe that the lessee does not have an unconditional right to use the asset. We observe that a lessee normally has limitations on the use of the leased asset. For example, in the case of a leasehold property the lessee cannot normally sub-let it to another third party and has no legal right to pledge it as collateral for borrowings. In the case of retail premises, such as a shop in a shopping mall, there will also be restrictions on the hours during which access to the premises is permitted and the type of leasehold improvements allowed. Moreover, in all cases the lessee does not normally hold significant risks and rewards of ownership as these are retained by the lessor. For example, if the leased asset is damaged or destroyed in the event of a fire the lessee will not be required to pay further lease payments until the asset has been restored to the original lettable condition. Given the above common examples of restrictions in use, we question whether a lessee has in fact an unconditional “right-of-use” as suggested by the IASB.

Rather we believe that lessee has in fact only a conditional “right-of-use”; that is, “right-of-use” is conditional on the lessee making the regular advance lease payments and complying with the restrictions on use. The lessee acts as a custodian for the leased asset. If the regular lease rental payments have not been made, there is no “right-of-use” and therefore no asset. Nevertheless, we would accept that an asset could be recognised, if and to the extent that there has been a prepayment of rent as this would represent a deferred expense, the benefits from which will arise in future periods when the leased asset is used.

- (b) Is a “commitment” to pay rental payments a liability?

A “liability” is defined in the Conceptual Framework as “*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits*”.

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We have stressed many times before that the IASB should draw a clear distinction between a “present” obligation and “future” commitments. In our view, a lease contract is an executory contract and the obligation of the lessee is to make a series of future transactions or rental payments. These “future transactions” are not “present” obligations but future obligations. When entering into a lease contract, the lessor has unperformed service obligations which have to be performed in the future. These include making the asset continuously available and also rectification of any structural and other defects that may arise in the future. Similarly, the lessee has an obligation to pay rentals but only if the asset is continuously made available to him in the appropriate condition throughout the lease term.

(c) Impact of the proposals on the treatment of other commitments

We are concerned that the proposals raise fundamental conceptual issues concerning how to account for other service contracts. Currently, accounting for operating leases and other service contracts, such as employment contracts, is similar. They are expensed only when incurred. If the principle proposed is conceptually sound, it should also apply to other service contracts. We question why the principle of recognising “right-of-use” applies to lease contracts only.

The possible consequence of the proposed standard is to similarly account for the “right-of-use” of employees (both permanent and contract staff), subcontractors and also undrawn bank overdrafts and credit facilities which similarly provide a “right-of-use”. It could also be argued that the principle should be applied to other commitments such as purchase orders for inventories and capital commitments. We believe the result of the proposals is inflation of items recognised in the balance sheet that are not assets or liabilities, and the ultimate effect is that financial statements will become less understandable and useful.

Because of the above concerns, we believe a more thorough analysis is needed on the conceptual basis and the wider implications of the proposals.

### Performance obligation approach

Paragraph 7 of IAS 40 “Investment Property” defines an investment property as follows:-

*“Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity.”*



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Under the proposals, when a lessor retains exposure to significant risks and rewards of ownership and measures its investment property at cost, the performance obligation approach is required to be adopted. Under this approach, the lessor records in its balance sheet both the “underlying asset” and the “right to receive rentals”.

We believe recognising the “right to receive rentals”, which is based on the future cash flows and economic benefits arising from property rental income, will amount to double-counting as the cash flows that give rise to the “right to receive rentals” relate to the cash flows associated with the investment property (“underlying asset”).

We are also unclear why investment properties which are stated as their fair value rather than cost, which is an accounting policy choice, are not included in the scope of the standard (paragraphs 7(b) and BC57). This raises the question of how entities holding investment properties stated at fair value will be accounting for their lease contracts.

### Options to extend and contingent rentals

The Exposure Draft proposes that at the inception of the lease contract the measurement of the present value of lease payments should be based on “*the longest possible term that is more likely than not to occur*” (paragraph B16) and the estimate of contingent rentals should be measured using the probability-weighted average amount of reasonably possible outcomes (paragraphs 14 and B21).

We consider rentals that may be receivable in the option period do not meet the definition of an asset or a liability. Until the option is exercised, the lessor does not have the right to receive rentals and the lessee does not have any obligation to pay rent. We also understand that in some lease contracts the option to extend or renew is available to both the lessor and the lessee and we envisage that there will be practical difficulties in making assessments of the likelihood of the exercise of the option as this will require input from both parties. In any event, we believe that the purpose of an option is for both parties to make a decision in the future, which can only be reasonably determined closer to the time the decision has to be made rather than at the inception of the lease. Any current expectations by either party can change as the circumstances change and the drivers of the change in decisions will be different for both parties.

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We believe that contingent rentals are “contingent liabilities” and the proposal to recognise these would be inconsistent with the current requirements under IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”. We also consider that contingent rentals are linked to the future performance of the leased asset and future performance may not be wholly within the control of the lessee or the lessor and therefore no liability or “right-of-use” asset should be recognised as they cannot be measured reliably. For example, when rental of retail space in a shopping mall is adjusted based on the sales turnover of the tenant, the range of possible contingent rentals may be very wide and any estimation will be very subjective. The proposal to require reassessment of lease payments in each reporting period acknowledges the fact that the estimated lease payments will be arbitrary and are based on assumptions which we believe cannot be verified or even properly audited. Any one of the assumptions could be invalid, which in turn could have a significant impact on the results and financial position of the reporting entity.

### Balance between benefits and cost

We note that paragraph 4 of the Exposure Draft states that the objective of the proposed standard “*establishes principles that lessees and lessors shall apply to report relevant and representationally faithful information to users of financial statements about the amounts, timing and uncertainty of the cash flows arising from leases*”.

We believe that the primary focus of financial statements should be to record “actual transactions” that faithfully reflect the entity’s true cash inflows and outflows. We are very concerned that the proposals on lease accounting lack simplicity in conveying relevant, reliable and faithful information. For example, for leases currently classified as operating leases, under the proposals “actual” rent expenses will be replaced by two elements; amortisation of the hypothetically determined “right-of-use” asset and interest expense. This information will not reflect the real cash flows of the entity. We believe the current requirements and disclosures for operating leases are in fact more informative and useful. We are concerned that the new approach would not improve the ability of users to understand financial statements but in fact will result in added confusion and facilitate the easier manipulation of the results and financial position of reporting entities.

We understand that in developing the proposed standard the Board carried some outreach activities to evaluate its costs and benefits. We would point out that entities are required to apply the same accounting policies throughout the year and costs of compliance will depend on the frequency at which an entity is required to report, whether internally or externally (e.g. annually, half-yearly, quarterly, monthly or daily). We therefore believe that compliance with the proposals, which will apply to all leased assets irrespective of the term of the lease, would be time-consuming and the cost of compliance to generate the information will outweigh the benefits.



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Its impact will also extend beyond just accounting systems and financial reporting. For example, we believe the change will have a substantial impact on leasing businesses and the business and financing models of both lessors and lessees, which in turn may lead to possible significant tax consequences. The proposals will also result in changes in key financial ratios and performance measures and these may in turn lead to a detrimental impact on whether loan covenants and capital and liquidity requirements are met.

We believe that the proposed requirements are conceptually inconsistent and the reported amounts would be highly subjective. In addition, the cost to produce the information would be unduly onerous and burdensome. We strongly question whether the resulting information provides useful, relevant and understandable information.

Because of the above concerns, we strongly believe that the Board should withdraw the Exposure Draft. The Exposure Draft raises wider and more fundamental conceptual issues of what is the meaning and the key attributes of an asset and a liability and when they should be recognised.

We hope that the above comments are useful.

Yours sincerely,  
For and on behalf of  
The Stock Exchange of Hong Kong Limited



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c.c. Mr. Charles Li – Chief Executive  
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