Hutchison Whampoa Limited

22 December 2010

International Accounting Standards Board
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London
EC4M 6XH
United Kingdom

Mr Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
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Dear Sirs,

IASB Exposure Draft *Leases* – Response to Invitation to Comment

We appreciate the opportunity to respond to your invitation to comment on the IASB Exposure Draft *Leases*.

The Group has a network of over 9,000 retail stores and over 30,000 telecommunications cell sites, with thousands of lease arrangements spread over more than 30 countries worldwide. It is our view that the proposed exposure draft is inappropriate and does not meet its stated objective of providing users of financial statements with a complete understandable picture of an entity's leasing activities.

The proposed exposure draft presumes that leasing is always a source of financing for a purchase of an asset or a right to use with delayed settlement ie the lessee is presumed to have committed to a purchase resulting in a liability to pay the consideration for the acquisition and consequently would incur interest expense on the liability to make lease payments, which are considered to be deferred payments. We believe that this is inappropriate as only in certain cases leases are a source of finance for an acquisition of an asset. In many cases, leases are commitments from lessors to lease an asset to lessees, in much the same way as directors enter into contracts with companies to provide director services or utility providers commit to supply their goods or commodities. In the typical retail lease of retail space or lease of a cell site, there is no purchase of property or land from nor financing provided by the lessor (the property owner). The lease payments in a typical retail lease reflect the price that the lessor is willing to lease the retail space to the lessee for the pertinent lease period.

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The accounting resulting from the exposure draft will distort the profit and loss statement and will not appropriately reflect the assets and liabilities arising from the lease. Whilst the exposure draft does not improve the reliability nor relevancy of the financial statements, it will make the accounting for leases significantly more complicated, increases the amount of work required from the preparers of financial statements and its auditors, whose costs will be ultimately borne by the preparers of financial statements and yet at the same time making the financial statements more difficult for users of the financial statements to understand.

Distortion of the profit and loss statement

The proposal that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payment will effectively front load the expensing of lease payments to the earlier years. This is not reflective of the commercial position in Hong Kong and many places in the world where lease payments will increase during a lease term (and not to reduce) to reflect an estimate of property inflation. This problem will be exacerbated with the proposed transitional provisions. In addition, it is inappropriate to have interest expense being recognised in the profit and loss statement when no financing has been provided by the lessor.

The proposal will reduce the usefulness of the profit and loss statement to both internal and external users of financial statements.

Distortion of the statement of financial position

The proposal to include a right-of-use asset and a liability to make lease payments based on the present value of lease payments over the longest possible term that is more likely than not to occur does not fairly reflect the financial statement preparer's contractual liability with regards to the lease obligations. Consequently the carrying balance for the right-to-use asset (which is there as a default to make the books balance) will not be representative of the value of the lease.

As mentioned earlier, we are of the view that the premise that all leases are forms of financing is incorrect. Consequently the proposal to set up a liability based on this premise is inappropriate.

We note that some concerns have been expressed that billions of lease commitments fail to appear on balance sheets of lessees. We would like to highlight that many leases in Hong Kong and the region have early termination clauses exercisable only by the lessee and therefore the liability as calculated above will overstate the preparer's contractual liability under its leases.

The proposal will not improve the reliability or relevancy of the statement of financial position.

Over complication

The proposal significantly increases the complexity of the accounting without any marked improvement or benefit to users of the financial statements but instead, as explained above, it will distort the financial statements making it more difficult for users to understand.

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The need to calculate the present value of the lease payments requires:

(1) The determination of an appropriate discount rate. As there is no financing provided by the vendor, there will be no actual transaction rate to be applied. The proposal is to derive or calculate a "rate of interest that, at the date of inception of the lease, the lessees would have to pay to borrow over a similar term, with a similar security, the funds necessary to purchase a similar underlying asset". Clearly not an easy number for management to derive or for auditors to concur upon.

(2) The determination of the lease term which is "the longest possible term that is more likely than not to occur". In practice, the lessee will try to obtain the longest lease term with the shortest termination period exercisable at the lessee's option possible. The actual lease period will be determined by the actual performance of the store. The expectation on inception will be the maximum lease term on the basis that the store will perform as expected. However, history will show that some store leases are terminated before the expiry of the maximum lease term due to lower than expected performances and other reasons. The determination of what is a reasonable lease term is therefore subject to considerable analysis and judgement.

The need to reassess the length of the lease term and the liability at the end of each reporting period will significantly increase work for the preparers and their auditors.

The requirement to apply IAS 36 *Impairment of Assets* at each reporting date to determine whether the right-of-use asset is impaired could be interpreted to bring down the cash generating unit to a lower level than previously applied, significantly increasing the work and judgement involved.

We believe that the cost of pre-adoption data gathering and reviewing of key terms, ongoing tracking of information and reassessing key measurement assumptions at each reporting period would be substantial and would outweigh the benefits, yet to be demonstrated, of the proposed model.

<u>Other considerations</u>

The exposure draft, if confirmed, would significantly impact a number of key financial ratios.

As mentioned earlier, reported profitability will be adversely affected during the earlier years of the leases. EBITDA and EBIT will improve even though there is no change in the cashflow or underlying performance. However, "interest expense" and "borrowings" will increase, adversely affecting interest coverage and leverage ratios, which could also affect loan covenants. In addition, the various subjective management judgements required including inter alia the discount rates and lease terms used in the present value calculation of the liability will affect comparability of financial statements. Consequently, reported numbers will most likely be adjusted for performance appraisals by internal and external users of financial statements.

We believe these issues need to be addressed before the exposure draft is adopted in its current or a revised form.

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If you have any questions about our comments, please contact Mr Kwan Cheung, Head of Financial Reporting and Planning on +852 2128 1468 or the undersigned on +852 2128 1206.

Yours sincerely
For and on behalf of Hutchison Whampoa Limited

Kwan Cheung

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