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Mr. Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

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Dear Steve,

IASB Discussion Paper on Preliminary Views on Leases ("Discussion Paper")

I refer to your letter to our Joseph Mau dated 5 May 2009 on the above which has been passed to me for my attention.

We have completed our review of the Discussion Paper and our views are set out in the paragraphs below.

General

The Discussion Paper sets out the preliminary views of the IASB and FASB (the "Boards") on proposals to develop a new accounting standard for leases.

The preliminary view in the Discussion Paper proposes that a lessee should recognise a "rights-to-use" asset and a liability for the obligation to pay rentals. We have concerns on the preliminary view as it will change fundamental principles of what should be recognised as assets and liabilities to include future commitments. If the proposals are adopted, it is likely that in future the principle of recognising rights-to-use could be expanded to other areas. We see a possible major consequence is to similarly account for employees as rights-to-use assets and to also recognise the "rights-to-use" bank overdrafts and credit facilities. The result is inflation of items recognised in the balance sheet.

We are also concerned that the proposals would make financial statements more complex and more difficult to understand as the measurement of the lease assets and liabilities by lessees will rely substantially on certain assumptions made by the lessee about its future expectations at the inception of the lease which will inevitably change. We also question whether the proposals will provide more meaningful and useful information to users of financial statements and whether the added cost of keeping the records and producing the information is justified.

香港交易及結算所有限公司
Hong Kong Exchanges and Clearing Limited

香港中環港景街一號國際金融中心一期12樓
12/F, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong
電話 Tel: +852 2522 1122 傳真 Fax: +852 2295 3106 網址 Website: www.hkex.com.hk 電郵 E-mail: info@hkex.com.hk

As the proposals are a fundamental change to current practice, we suggest that the Boards proceed with extreme caution and thoroughly field test its proposals before finalising accounting standards on leases for both lessees and lessors.

<u>Deferral of discussion and analysis of lessor accounting</u>

The Discussion Paper focuses on the accounting for leases by lessees and the discussion and analysis of accounting for leases by lessors has been deferred for the reasons stated in paragraph 1.21 in the Discussion Paper.

We disagree with this approach. Discussion of lessor accounting at a later stage is likely to induce further discussion on lessee accounting and will likely bring changes or amendments to the "finalised" accounting standard for lessees. This approach is inefficient, will confuse both preparers and users of financial statements and adds to wasted costs.

If an accounting standard for lessees based on the proposals is issued before an accounting standard for lessors is issued, lessors may continue to recognise an asset in respect of the same economic resource and as a result there will be double-counting. Also, we believe that the accounting standard for leases by lessees should be symmetric to an accounting standard for leases by lessors. As identified in the Discussion Paper, how and when to recognise and derecognise an asset that is leased is a key issue and we believe that it has yet to be fully explored and resolved.

To seek views at this time purely from the perspective of the lessee is dangerous and may result in inappropriate decisions being made as all relevant issues would not have been fully analysed and properly considered.

We believe that a more appropriate approach would be to consider both the accounting for leases by lessees and lessors at the same time in order to identify and address all the conceptual and practical issues that will arise in accounting for lease contracts. We believe a comprehensive approach is more likely to reveal all the relevant issues and will also enable both lessors and lessees to implement a revised accounting standard on leases at the same time.

<u>Recognition of an asset and a liability for a lease</u>

Paragraphs 3.16 and 3.20 of Chapter 3 in the Discussion Paper concluded that the "rights-to-use" a leased item by the lessee qualifies the recognition of an asset, and the obligation to pay future rentals qualifies the recognition of a liability. We believe the analysis leading to these conclusions was insufficient and suggest that it be studied in greater depth together with an assessment of its implications including how the principle may be expanded to other circumstances and transactions.

The issue of lease accounting raises a Framework issue of what is an "asset" and what is a "liability", and the current Framework stresses the need for differentiating these from future commitments and contingencies which should be dealt with through disclosures in financial statements.

Paragraph 3.16(a) of the Discussion Paper argues that because "*the lessee controls the rights to use the leased item*" an asset should be recognised. However, the Discussion Paper only briefly but does not fully explain how the rights-to-use a leased item should be regarded as being something "controlled" by the lessee.

The current 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. Legal or other methods of holding the risks and rewards of ownership provide the holder of the item the ability to unilaterally determine how the item will be used, that is, the form and nature of the future economic benefits to be derived from the item. For example, in the case of a building the owner/controller will determine whether it should be sold, used a factory building to house plant and machinery for a production process or leased out as an investment property to gain rental income. We believe that for an asset to be recognised, its holder should also have control over the item and for control to exist, the "controller" should have no restrictions on how he may make use of the item.

In the case of a lease, we believe a lessee does not have unilateral control to do whatever he likes but only has restrictive use of the leased item; for example, a lessee who leases a retail shop has no risks and rewards of ownership and cannot sell it, decorate it freely, cannot sub-lease it to another third party or use it for a purpose other than that allowed by the lessor. A lessee does not have unilateral control but only has temporary access to the leased item. We therefore question whether a lessee in fact "controls" the leased item given these restrictions and whether an asset should be recognised for the rights-to-use.

The lessee may be required to pay a security deposit for damage to the rented item and the deposit should be regarded as an asset of the lessee as it is recoverable from the lessor unless the item is damaged. If rent has been prepaid for the full lease term on signing the contract, we agree that in such circumstances it would be appropriate to recognise an asset for the amount paid as it represents a deferred cost or expenditure that has been incurred, the benefits from which will accrue in the future. This is consistent with the recognition of other rights-to-use such as mining rights, where consideration is paid up front.

Moving onto the second issue of whether commitments to pay rental payments results in a "liability", paragraph 3.20(a) of the Discussion Paper states that "*the lessee has a present obligation to pay rentals*". We believe the existence of an obligation per se does not

necessarily amount to a liability. Our analysis is that a lease contract results in obligations but the obligation to pay future rentals is not a "present" obligation.

A "liability" is defined in the 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*". We believe that when the Framework was developed the word "present" was intentionally added to distinguish immediate or present obligations from future obligations and commitments. Paragraph 61 of the Framework stresses and draws a distinction between a present obligation and future commitments.

Although a lease agreement is an enforceable contract, the obligation is a commitment to make a series of future transactions or rental payments. These "transactions" should not be recgonised until there has been an appropriate exchange of goods and services, that is, for example a landlord, in providing premises to the tenant and the tenant or lessee, in paying the agreed rent.

There is no present obligation to pay all the months rent covered under the lease agreement on the signing of a lease contract which is the substance of the conclusion adopted in the Discussion Paper. We believe a "present obligation" only arises when a good or service has been delivered or exchanged. However in the case of a lease, the rent is only payable in the future and is contingent on the leased item being made available to the lessee. On the signing of the lease contract, the lessor has unperformed service obligations which have to be performed in the future. If the leased item is destroyed or made non-useable, say by fire, the lessee would have no obligation to pay rentals.

In summary, we believe a lease contract is an executory contract and represents an agreement in which both parties have performed some of their promises while other promises have yet to be honoured. Both the lessor and lessee have future obligations to perform. A lessor's obligation is to initially make, and then to continue to make, the leased item available to the lessee over the lease term. If, and only if the leased item is made available to the lessee to use, the lessee's obligation is to pay the rents when due.

We are concerned that if the principles set out in the Discussion Paper are applied to other transactions, it is conceivable that many expense items for goods and services currently recognised in the income statement could also be viewed as rights-to-use and should be treated as leases and similarly accounted for in accordance with the proposals in the Discussion Paper. The fundamental issue is whether each "transaction" should be accounted for separately or whether in accordance with the Discussion Paper an agreement to transact in the future triggers the recognition of an asset or liability for the aggregate of all future transactions. The fundamental question under consideration is whether all agreements or commitments to exchange goods and services in the future should be recognised as assets and liabilities at inception of the agreement.

Because of the above, we believe a more thorough discussion and analysis is needed to justify the recognition of an asset and a corresponding liability on lease contracts by lessees.

<u>Rights to extend leases and impact on comparability and complexity of financial statements</u>

Currently, a lessee does not recognise options to extend a lease and lease payments are recognised in the income statement as incurred.

The Discussion Paper proposes that at the inception of the contract the measurement of the lessee's obligation to pay rentals should be based on the estimated "most likely" term of the lease and contingent rents payable. We believe this is not an appropriate approach and its adoption would make the financial statements more complex and difficult to understand.

The purpose of an option is to provide the lessee with the ability to determine whether it is economic to continue the lease, some time in the future, based on the status of the lessee's business near the end of the original lease term. Forcing him to make this determination at the inception of the lease is unrealistic, will be very subjective and will be difficult to properly audit. Moreover, in many cases the option to extend or renew is available to both the lessor and the lessee and in these cases we envisage the lessee will face practical difficulties in his assessment of the most likely lease term as input from the lessor will be necessary and the lessor is likely to be non-committal.

<u>Structuring leases to achieve a desired outcome</u>

The Discussion Paper notes the concern that lease contracts may be restructured to achieve a desired outcome. The problem is not unique to leases. We believe that unless there is conveyed a key message in the Framework or an underlying general principle that preparers of financial statements are required to comply with both the spirit and intent of an accounting standard rather than just its form, this will be a perennial problem that will never be resolved.

<u>Impact on entities which enter into numerous operating leases</u>

Certain businesses enter into numerous leases as lessees for example; retailers, supermarkets, restaurants, banks, telecommunication service providers and transport companies. If the proposals in the Discussion Paper are adopted, there would be a significant increase in the assets and liabilities shown in the balance sheets of these entities. Financial ratios specified in loan covenants and used for other purposes, such as Chapter 14 of the Listing Rules, which are based on the amounts shown in an entity's balance sheet would change significantly but there would be no significant change to the entity's income statement or cash flows. We therefore doubt whether the proposed

approach provides more useful and meaningful information to users of financial statements. Moreover, the cost of implementing the proposals is likely to be significant and we wonder whether the cost is justified.

We believe that there should be a sound conceptual basis for all accounting standards that are developed. Standards should be conceptually consistent, practical and cost effective in producing useful and easily understood information. We are concerned that the Boards are possibly moving away from this. One of the main purposes of financial statements is to inform and to enable readers to assess future cash flows. The current standard for operating leases achieves this by indicating clearly and simply the yearly rental outflows charged through the income statement and the disclosure of annual lease commitments that will be incurred in future years. We believe the proposed approach in the Discussion Paper lacks simplicity in conveying relevant and reliable information. Instead it appears to add complexity, cost and will facilitate manipulation.

We hope that the above comments are helpful in further developing a conceptually sound standard on leases.

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

Colin Chau
Senior Vice President
Listing Division

CC/el

c.c. Mr. Joseph Mau – Company Secretary
Mr. Mark Dickens – Head of Listing