SWIRE PACIFIC

International Accounting Standards Board
Working Group on Leases
30 Cannon Street
London EC4M 6XH
United Kingdom

For the attention of Rachel Knubley

3rd July 2009

Dear Sirs

Discussion Paper: Leases Preliminary Views

We are responding to your invitation to comment on the above Discussion Paper, published in March 2009, on behalf of Swire Pacific Limited.

Overall comments

We welcome the opportunity to respond to the Leases Discussion Paper. We support the joint efforts by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to reduce diversity in accounting treatments and complexity of lease accounting. However, whilst we agree that the existing standard on lease accounting (IAS 17) requires further improvement, we do not support the tentative decisions made by the boards outlined in the Discussion Paper.

In our view, the proposed model for lease accounting will not enhance the quality and usefulness of financial information provided to the primary users of the financial statements. By accounting for all lease arrangements in the same way, the financial statements will not accurately reflect how management manages a business. One of the key considerations of asset management (indeed we believe the overriding consideration in most cases) is to manage the exposure to residual value risk. The proposals in the Discussion Paper require airlines to recognise existing aircraft operating leases on the balance sheet as assets since all leases would be accounted for as financing leases. However, management does not necessarily enter into these leases as a means of financing but as a means of managing exposure to residual value and to benefit from the flexibility that operating leases provide. Accounting for the leases as operating leases therefore reflects the commercial reality of management decision-making. By eliminating the operating lease treatment we believe that this important distinction will be lost.

The proposed model will remove meaningful information relating to the nature of the leased assets from the financial statements. The users of the financial statements may interpret recognition of an asset on the balance sheet as having transferred the residual value risk to the airline. However, in practice the residual value risk of the aircraft continues to reside with the lessor, the airline is only exposed to contractual obligations under the lease.

Swire Pacific Limited
35/F Two Pacific Place 88 Queensway Hong Kong Fax (852) 2845 4876 www.swirepacific.com

Sophisticated users (such as analysts) of the financial statements would prefer to have more information about the lease arrangements, in particular if they are 'in substance purchases' or 'other leases', so that they can make adjustments to the financial metrics according to their own need. The proposed approach potentially provides less information to these users. It is also not clear to users (for less sophisticated users in particular) that for 'in substance purchases', the lessee only bears a right to use the asset but does not own the asset.

One solution would be to disclose information on residual value risk and ownership, in addition to the proposals in the Discussion Paper. However, to make these disclosures it would seem likely that some form of distinction would need to be made between those leases which are 'in-substance purchases' and those which are not, which means that some form of 'classification' would still need to be made. You allude to this in section 8 of the Paper when considering presentation. However, we believe this warrants significant further investigation by the boards, not only as a matter of presentation but also when considering recognition.

In addition to concerns about the need to adequately reflect residual value risk and ownership, we have a number of concerns with the tentative decisions in the Discussion Paper. The more significant of these include:

- Inconsistency between the proposed measurement approach for liabilities and existing standards. The proposed model requires the lessee to consider renewal options and contingent rentals when calculating the lease obligation. However, as the option/contingent rental is not a present obligation and does not arise out of a past event, it does not meet the definition of liability under the Conceptual Framework or existing standards. Similarly, the proposed model requires the lessee to reassess the discount rate at each reporting date while IAS 39 does not require such reassessment.
- The mismatch between the recognition of the 'financing' expense and the economic benefits realised from the lease. Under the proposed model, the asset is typically amortised on a straight-line basis while the obligation is accounted for using the effective yield method. Together, this will lead to higher expenses during the early part of the lease term and lower expenses during the latter part of the lease term. This may deviate from the timing of recognition of the economic benefits. For an aircraft operating lease, for example, the economic benefits from the lease are the same throughout the lease period. However, under the proposals, the airline will record a higher financing expense at the early part of the lease and a lower financing expense at the latter part.
- The increase in complexity which the proposals would bring, for example, reassessment of the lease term, contingent rentals and residual value guarantees at each reporting period, and the resulting management time and cost involved. We are particularly concerned that existing leases may not be grandfathered on first time adoption.
- The application of the standard to 'non-core' and low value assets. We believe that these should be excluded from the scope since the information will be of little value to users of the financial statements but requires substantial effort to prepare. This should not be an area of focus for the boards.

- Distortion of financial metrics resulting from the increased level of financial liabilities recorded on the balance sheet, in particular from liabilities recognised under the proposed approach which the company could in practice avoid at no cost (for example by not exercising an option). The effect on existing covenants may lead the banking industry to restrict lending to some companies.
- The lack of a comprehensive cost-benefit analysis which we believe should be performed before the proposals are justifiable.

Alternative approach

We feel that the boards will better serve the needs of users of the financial statements by enhancing the existing standard rather than replacing the existing lease accounting standard with a new, more complex standard. Our recommended approach is as follows:

- Remove the structuring opportunities in the existing standard. We recognise that one of the criticisms of the existing lease standard is that companies have successfully structured leases in order to avoid having to recognise assets on the balance sheet. However, we believe that the proposed model will result in existing structuring opportunities merely being replaced by new opportunities. We recommend that the structuring opportunities in the existing standard be removed by re-writing the standard as a principle-based standard focusing on the difference in substance between an 'in-substance purchase' and 'other leases'.
- Enhance the disclosure requirements for 'other leases', for example (i) require future minimum lease payments to be disclosed over the expected lease term by years in the next five years and the rest grouped under 'after five years'; and (ii) require additional qualitative and quantitative disclosures of other features in the lease such as options, contingent payments and guarantees.
- For 'in-substance purchases,' make the liability recognition and measurement consistent with the requirements related to liabilities under existing standards. This should be simple to follow and produce a number which is well understood by all.

We have responded to the specific questions raised in the invitation to comment in the Discussion Paper in an Appendix to this letter. We support the boards' efforts to improve financial reporting and converge to one set of global accounting standards. However, we believe the boards should reconsider those aspects of the Discussion Paper noted above prior to issuing an exposure draft. We would welcome the opportunity to discuss these views with you in further detail. If you have any questions regarding our comments, please do not hesitate to contact the undersigned on +852 2840 8676 or at clarke@swirepac.com.

Yours faithfully,

Aw Clarke

For and on behalf of Swire Pacific Limited
Andrew M. Clarke
Finance Manager

Encl.

Appendix

Question 1
The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards.
Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Response
We believe it is appropriate to base on the scope of the existing lease accounting standard (IAS 17).

Question 2
Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.

Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Response
We believe non-core asset leases and short-term leases should be excluded as we do not believe the case for their inclusion has adequately been made. Whilst it may be possible for these amounts to be significant in aggregate, we do not believe that these leases are an area of focus for users of the financial statements but the information requires substantial effort to prepare. Recognising the costs in the income statement as incurred provides sufficient information to users in a manner which is manageable for companies without undue expense.

We believe that in defining non-core and short term leases, the boards should make reference to the relevance of the leases to the business of the entity and the life of the lease in comparison to its operating cycle. In addition, the definition should not include any 'bright-line tests' (for example, the 90% test under the existing model).

Question 3
Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Response
We are not fully persuaded by the analysis included in the Discussion Paper. Whilst the rights and obligations of the simple lease contract are described sufficiently, it is difficult for these to meet the definition of an asset or liability. For example, in order to meet the definition of an asset, the lease must arise out of a past event. We are not persuaded that the signing of the lease constitutes a past event as it can be argued that the lessor is required to provide ongoing delivery of the leased asset over the entire lease term.

We also consider that the Paper does not provide a clearly defined triggering point for when to recognise an asset and liability. The distinction between a lease and an executory contract is unclear. Section 9 (para. 9.5(a)) of the Paper suggests that if a lease is signed but the asset has not yet been made available, this would be an executory contract as each party is still to perform. This suggests that making the asset available and making the payment are both a performance requirement of the contract. This seems to contradict the assumptions in section 3 (specifically para. 3.16(b)) which discusses the non-performance of the lessee and breach of contract but dismisses the ongoing obligation to perform (make the property available and make payments), indicating that leases do not meet the definition of an executory contract.

We also share the concerns of the boards in respect of the meaning of control in the context of an asset. In our view, the boards have not clearly indicated what control means in this context and we urge them to reinforce the principle of risks and rewards and to develop the thinking included in IFRIC 4 on this matter for broader application.

In addition, we would encourage the boards to consider further the difference between 'in-substance purchases' and 'other leases' and apply this classification to the existing model of finance and operating leases, albeit with additional disclosures to help users understand the cash flow commitments of 'other leases'.

Question 4
The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
(b) a liability for its obligation to pay rentals.
Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

Response
We do not support the proposed approach as we believe;

i. It removes meaningful information on the nature of the leased assets from the users of financial statements, such as whether the leased assets are 'in-substance purchases' or 'other leases';
ii. It does not reflect how management manages the business since all leases will be accounted for as financing leases, while management does not necessarily enter into these leases as means of financing but as a means of managing exposure to residual value and to benefit from the flexibility that operating leases provide; and
iii. If implemented in the manner that the boards are proposing, it will be difficult to apply and inconsistent with existing standards and the Conceptual Framework, for example, the proposed model is not clear on determination of the incremental borrowing rate and a renewal option does not meet the definition of liability.

We also do not support the components approach for the same reasons as articulated in paragraph 3.32 of the Paper.

Instead, we would encourage the boards to consider further the difference between 'in-substance purchases' and 'other leases' and apply this classification to the existing model of finance and operating leases, albeit with additional disclosures to help users understand the cash flow commitments of 'other leases'.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Response
Refer to our response to Question 4 above. In addition, we do not believe that contingent rental arrangements or residual value guarantees meet the definition of liabilities under existing standards and the Conceptual Framework (refer to our responses to Questions 15 and 16).

Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Response
We generally agree with the present value approach for 'in-substance purchases'. As noted in the Paper, use of the rate implicit in the lease is more appropriate for these types of leases and so we support its continued use. In addition, there are practical difficulties with the use of an incremental borrowing rate; companies that do not have a credit rating or external funding will find it difficult to determine their incremental borrowing rate. Also it may be difficult to determine an incremental borrowing rate for a specific asset when a pool of funding is used to finance asset purchases.

We do not support the recognition of 'other leases' for the reasons articulated in our covering letter.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?
If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Response
We believe it is appropriate to measure the 'in-substance purchase' asset at cost.

Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.
Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

Response
We agree with the proposed amortised cost-based model for 'in-substance purchases'. However, we do not agree with the reassessment of the discount rate as this is inconsistent with how amortised cost is determined in IAS 39. Reassessment causes an unnecessary fluctuation of financing expense and it is also costly and time consuming.

We do not support the recognition of 'other leases' for the reasons articulated in our covering letter.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Response
We do not believe the new lease accounting standard should permit the election of measuring rent obligation at fair value. We believe fair value measurement of rent obligation may yield unacceptably wide ranges of valuation results. In our view, this will diminish comparability amongst preparers, and potentially increase volatility caused by imprecise measurement, both of which may ultimately reduce the usefulness of financial reporting.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows?
Please explain your reasons.

Response
As noted in our response to Question 6 above, we support the continued use of the rate implicit in the lease for 'in-substance purchases' rather than use of the incremental borrowing rate. There are practical difficulties with the use of an incremental borrowing rate; companies that do not have a credit rating or external funding will find it difficult to determine their incremental borrowing rate. Also it may be difficult to determine an incremental borrowing rate for a specific asset when a pool of funding is used to finance asset purchases. Revising this rate is also inconsistent with the requirements of IAS 39 when determining amortised cost.

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

Response
A financial liability under IAS 39 requires fair value measurement at initial recognition and an entity may elect to measure the financial liability at fair value. As discussed above, we do not believe fair value measurement is appropriated for an obligation created by an 'in-substance purchase'. We believe the amortised cost model will better reflect value of the assets, is simpler and well understood in the market, which will increase comparability of the financial information. We also believe that there are grounds for differentiating the treatment under lease accounting from IAS 39 as both the leased asset and liability are with the same party.

We do not support the recognition of 'other leases' as liabilities for the reasons articulated in our covering letter.

Question 12
Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.
Would you support this approach? If so, for which leases? Please explain your reasons.

Response
We believe that 'in-substance purchases' should be treated as assets based on the nature of the underlying assets and depreciation expense recognised accordingly. We do not support the recognition of 'other leases' for the reasons articulated in our covering letter. Instead, rental expenses on 'other leases' should be recorded as incurred.

Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Response
We do not agree with this approach. It appears to be inconsistent with the definition of a liability in existing standards and the Conceptual Framework as there is no obligation as a result of a past event. It is also impractical to make estimates of the most likely lease term for genuine operating leases at the inception of the lease as the decision may change depending on the results of ongoing operations.

We do, however, recognise that without a substance based test these clauses could be used for structuring, and we therefore urge the boards to consider this point when considering the distinction between 'in-substance purchases' and 'other leases'.

Question 14
The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.
Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

Response
We believe that the reassessment of the lease term should be considered only when there is an event (for example exercising an extension option) which causes reassessment rather than at each reporting period. This approach produces a number which is well understood and simple to monitor and which also reflects genuine changes in circumstances.

Question 15
The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.
Do you agree with the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Response
We disagree with the proposed approach. In our view, purchase options do not meet the definition of liability and therefore the proposed approach is inconsistent with the existing standards and the Conceptual Framework. Instead, we believe the existing approach under IAS 17 should be followed (i.e. recognition of the obligation when the option is exercised or at inception if highly likely to be exercised).

Question 16
The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.
Do you support the proposed approach?
If you disagree with the proposed approach, what alternative approach would you recommend and why?

Response
We disagree with the proposed approach as contingent rental arrangements do not meet the definition of a liability under existing standards and the Conceptual Framework. We believe the existing approach under IAS 17 should be followed (i.e. recognition of the obligation when the event occurs or at inception if the contingent rentals are in substance minimum lease payments).

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Response
As noted above in our response to Question 16, we do not believe that the rental obligation should include contingent rental payments.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

Response
Rather than including the estimated contingent value in the measurement of the liability which will not be easily understood by users and is not considered transparent, we feel that the existing approach under IAS 17 (supplemented with additional disclosures as described in our covering letter) will provide more relevant information to users by informing them of the nature and timing of the contingency.

Question 19
The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

Response
We do not support the proposed approach as we do not believe that contingent rentals meet the definition of a liability under existing standards and the Conceptual Framework. Contingent rentals should be recognised as and when the contingency occurs.

Question 20
The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons.
If you support neither approach, please describe any alternative approach you would prefer and why.

Response
We do not support either possible approach as contingent rental arrangements do not meet the definition of a liability under existing standards and the Conceptual Framework. Contingent rental payments should not be estimated since the definition of liability has not been met until the contingency occurs.

Question 21
The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Response
We consider there is a fundamental difference between a residual value guarantee and contingent rentals. Residual value guarantees result in the lessee assuming the residual value risk. This is a key management decision and one which we believe is of significance to a user of the financial statements. We believe that residual value guarantees should be taken into consideration in determining whether there is an 'in-substance purchase' lease or 'other lease'. The residual value guarantee would form part of the lease obligations of the 'in substance purchase' under the existing approach of IAS 17.

Question 22
Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

Response
We believe 'in-substance purchases' should be presented separately in the statement of financial position distinguished by the nature of the assets.

We do not support the recognition of 'other leases' as liabilities for the reasons articulated in our covering letter. In our view, 'other leases' should be disclosed in the notes rather than presented in the statement of financial position.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.
How should the right-of-use asset be presented in the statement of financial position?
Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

Response
We agree with the boards' view that a leased asset is significantly different from an owned asset. We also believe that this section highlights a key consideration which has been overlooked in the Discussion Paper as currently drafted, which is that there is a difference between a lease which is an 'in-substance' purchase and one which is not and that this information is useful for users of the financial statements.

We believe 'in-substance purchases' should continue to be presented in accordance with the nature of the underlying assets (i.e. property, plant and equipment) as mentioned in para. 8.9(c).

We do not support the recognition of 'other leases' as liabilities for the reasons articulated in our covering letter. 'Other leases' should be disclosed in the notes rather than presented in the statement of financial position.

Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Response
We believe the boards should address whether there is grandfathering clause for existing leases. If the boards do implement the proposals in the Discussion Paper, we feel that companies will be placed under an undue burden if there is no grandfathering clause for existing leases.

Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Response
We believe that for an 'in-substance sale' the rentals meet the definition of an asset as they are a receivable from the lessee.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or
(b) recognition of a performance obligation by the lessor.
Which of these two approaches do you support? Please explain your reasons.

Response
We consider that for an 'in-substance' sale, the asset should be derecognised, but for 'other leases' the asset should remain on the balance sheet.

We believe that it is inappropriate to derecognise an asset subject to only a short term lease as the risks and rewards of ownership of the asset over its economic life continue to reside with the lessor.

We also urge the boards to consider performance obligation as this seems to suggest that the contract is executory. We do not believe that a contract should be considered executory by one party to the contract but not the other.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Response
We consider that the boards should explore when it is appropriate for a lessor to recognise income. We are concerned that by concentrating on lessee accounting, there will be inconsistencies in accounting by lessors and lessees which will not be well understood by users.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Response
We do not consider that investment properties should be included in the scope of any new standard.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

Response
No other issues noted.