



3 April 2009

**To: Members of the Hong Kong Institute of CPAs
All other interested parties**

INVITATION TO COMMENT ON IASB DISCUSSION PAPER ON *PRELIMINARY VIEWS ON LEASES*

Comments to be received by 3 July 2009

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Discussion Paper which has been posted on the Institute's website at:

www.hkicpa.org.hk/professionaltechnical/accounting/exposedraft/content.php

Lease accounting under US GAAP and IFRSs is often criticized as being too reliant on bright lines and subjective judgements. Many believe that such reliance has resulted in economically similar transactions being accounted for differently and has presented opportunities for entities to structure transactions to achieve a desired accounting effect.

In the Discussion Paper the IASB and the FASB (collectively the boards) discuss a possible new approach to lease accounting. The boards propose that lease accounting should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position. This approach is aimed at ensuring that leases are accounted for consistently across sectors and industries.

The boards have not yet discussed the method of transition or the effective date. Those issues will be discussed after comments are received on this Discussion Paper, and included in the provisions of a subsequent exposure draft of the proposed standard.

The boards also decided to defer consideration of lessor accounting in order to resolve the problems associated with lessee accounting as quickly as possible. Consequently, the discussion paper deals mainly with lessee accounting. However, it also describes some of the issues that will need to be addressed in a future proposed standard on lessor accounting.

--- A summary prepared by the IASB on the Discussion Paper is set out in the attached Appendix.

In accordance with the Institute's Convergence Due Process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the proposals contained in the IASB Discussion Paper.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IASB Discussion Paper to be considered, they are requested to be received by the Institute on or before **3 July 2009**.



Comments may be sent by mail, fax or e-mail to:

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Comments may be made available for public review unless otherwise requested by the contributor.

Snapshot: *Leases—Preliminary Views*

This snapshot is a quick introduction to the discussion paper *Leases—Preliminary Views*. The project is being undertaken jointly by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). The purpose of the Snapshot is to provide a first insight into the major ideas presented in the discussion paper.

Project objective:	Creation of a common standard on lease accounting to ensure that the assets and liabilities arising from lease contracts are recognised in the statement of financial position.
Project stage:	The boards have published a discussion paper that sets out their preliminary views on accounting for leases by lessees and describes some of the issues that they will need to resolve in developing a new standard on lessor accounting. The objective of the discussion paper is to explain the issues and to solicit comments early on in the process.
Comment deadline:	The DP is open for public comment until 17 July 2009.
Next steps:	The boards are now seeking feedback on their proposals. They will consider that feedback in public Board meetings as they develop an exposure draft of a proposed standard. The publication of an exposure draft is planned for 2010.



Why are we undertaking the project?

According to the World Leasing Yearbook 2009, in 2007 the annual volume of leases amounted to US\$760 billion. However, the assets and liabilities arising from many of those contracts cannot be found in entities' statements of financial position (balance sheets).

This is because IAS 17 *Leases*—and the equivalent requirements in US generally accepted accounting principles (US GAAP)—splits leases into two categories: finance leases (called capital leases under US GAAP) and operating leases. If a lease is classified as a finance lease, assets and liabilities are recognised in its statement of financial position. For an operating lease the lessee simply recognises lease payments as an expense over the lease term.

This current approach in IFRSs and US GAAP is based on the assumption that finance leases, unlike operating leases, are similar to the purchase of an underlying asset that is financed by a loan and should therefore be recognised in the statement of financial position.

This split into finance and operating leases has given rise to a number of problems:

- **Users complain that financial statements do not depict clearly the effects of operating leases.^{*}**

Many users think that operating leases also give rise to assets and liabilities. Therefore they think lessees should recognise operating leases in their financial statements. As a result they routinely adjust the recognised amounts in an attempt to understand the effect of those assets and liabilities on the statement of financial position.

* The term 'Users' generally means investors and analysts and others that use financial statements of an entity to make investment decisions

Only finance leases are currently recognised on the balance sheet.

- **Similar transactions can be accounted for very differently.**
The split between finance leases and operating leases means that economically similar transactions can be accounted for very differently. This reduces both the transparency of accounts and comparability for investors.
- **The standards provide opportunities to structure transactions so as to achieve a particular lease classification.**
If a lease is classified as an operating lease the lessee obtains a source of off balance sheet financing that can be difficult for investors to understand.

What is the scope of the project?

A wide range of entities across all industries lease assets. Examples of leased assets include real estate, vehicles, plant and equipment. Lease contracts are an important source of assets and finance to business.

A new standard on lessee accounting could affect any entity that leases items as a lessee. Accounting would change significantly for leases that are now classified as operating leases. Entities that lease assets under finance leases at present would also be affected by changes in the way leased assets and liabilities are measured.

The boards decided in July 2008 to defer consideration of lessor accounting to resolve the problems associated with lessee accounting as quickly as possible. Consequently, the discussion paper deals mainly with lessee accounting. However, the final chapter of the discussion paper outlines some of the issues that will need to be resolved in developing a new standard for lessors.

Accounting would change significantly for leases that are now classified as operating leases.

Issues covered by the discussion paper

The boards have discussed the following lessee accounting issues that are now open for public comment:

- project scope
- recognition of the assets and liabilities arising in a lease contract
- initial measurement of the assets and liabilities arising in a lease
- subsequent measurement of those assets and liabilities
- accounting for leases with options (eg purchase, renewal and termination options)
- accounting for contingent rentals
- accounting for residual value guarantees
- presentation of leases in the financial statements.

The boards have also discussed lessor accounting including:

- a new approach to lessor accounting
 - subleases
 - other lessor considerations.
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Our initial ideas for a new approach

The boards have analysed lease contracts and, in line with the views of many users of financial statements, have concluded that, whether classified as operating leases or as finance leases, lease contracts always create rights and obligations that meet the boards' definitions of assets and liabilities.

Leasing a machine, for instance, gives the lessee the right to use the machine and creates an obligation to pay rentals whether or not the lessee obtains substantially all the risks and rewards of ownership of the machine.

On the basis of their analysis the boards believe that the underlying principle for a new model on lease accounting should be:

Lease contracts create assets and liabilities that should be recognised in the financial statements of lessees.

If this principle is adopted in a new standard on lease accounting, it would result in the lessee recognising:

- an asset for its right to use the leased item (the right-of-use asset)
- a liability for its obligation to pay rentals.

The boards think that ensuring that all leases are depicted on the statement of financial position would significantly increase the transparency and the comparability of lease accounting.

The boards have also discussed how to account for more complex lease contracts, such as leases that contain options to renew or terminate the lease, options to purchase the leased item, contingent rental arrangements or residual value guarantees.

If this principle is adopted in a new standard on lease accounting, it would result in the lessee recognising:

- an asset for its right to use the leased item (the right-of-use asset)
- a liability for its obligation to pay rentals.

What happens now?

In the discussion paper the boards propose not to require lessees to recognise renewal, termination or purchase options separately. Instead the lessee would determine whether the option will be exercised. For example, a five-year lease of real estate may include an option to renew the contract for an additional five years. Rather than recognising the renewal option as a separate asset, the lessee would determine the most likely outcome—will the lessee exercise its option or not? If exercising the option is the most likely outcome, the lessee would recognise a right to use the real estate for 10 years and an obligation to pay 10 years of rentals.

The boards propose not to require lessees to recognise renewal, termination or purchase options separately.

The boards also propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements and residual value guarantees.

The IASB and FASB are now seeking comments on their preliminary views. Although only the first step towards a new standard, the discussion paper is an important step, because the responses to it will help the boards in shaping proposals for a new standard on lease accounting.

The deadline for comments on the DP is 17 July 2009. To view the discussion paper and submit your comments, visit www.iasb.org or www.fasb.org. The discussion paper includes specific questions on the boards' proposals. Respondents may choose to answer all or selected questions but are also welcome to comment on any other matter that they think the boards should consider. The boards' deliberations will, as usual, take place in public board meetings as announced on the boards' websites.

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