CPA Hong Kong Institute of Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

17 July 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Discussion Paper on *Preliminary Views on Leases*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper. Our responses to the questions raised in your Discussion Paper are set out in the Appendix for your consideration.

Lease contracts are very important sources of financing for entities and we agree with much of the criticism set out in the Discussion Paper concerning the existing accounting standard on leases. We are supportive of the proposed "right-of-use approach" to lease accounting. Under this new approach, all lease transactions should be accounted for using a single model that results in the recognition by a lessee of an asset for its right to use and a liability for its obligation to pay rentals. We believe that the proposed approach will enhance the comparability for financial statement users and reduce structuring opportunities to keep assets and liabilities off the balance sheet.

However, some constituents in Hong Kong have expressed concerns that the analysis to justify the recognition of assets and liabilities is not adequate and implementation of the proposed standard may not provide more useful and meaningful information to users of financial statements.

On balance, the Institute generally agrees that the proposed "right-of-use approach" to lease accounting is moving in the right direction.

In addition, we have the following concerns regarding the Discussion Paper:

- A lessee should not have to revise its obligation to pay rentals for changes in the incremental borrowing rate.

- The model results in the recognition of a liability to pay rentals in respect of possible future extensions to the lease term that are at the option of the lessee. We do not believe these potential cash flows meet the definition of a liability, which requires there to be an obligation to pay cash or other resources of the entity, unless or until the lessee exercises the extension option.

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- The contingent rental payment linked to the performance of the asset should not be taken into account when determining the obligation to pay rental. This type of payment is more like executory contracts that should be expensed as incurred.

In addition, although we understand the reasons for deferring the consideration of lessor accounting, we believe that lessor accounting is also important in determining the key principles underlying the new lease accounting model and ensuring compatibility in treatment. This is particularly important in the context of sub-letting arrangements. We therefore believe that the Board should develop the lessor accounting model alongside that for lessees.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong

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APPENDIX

Hong Kong Institute of CPAs

Comments on the IASB Discussion Paper on *Preliminary Views on Leases*

<u>Question 1</u>

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.

It is conceptually preferable to having a single, universally-applied principle on lease accounting. Given the importance of this project, in order not to delay the issue of the final lease standard until mid-2011 as contemplated in the updated Memorandum of Understanding, we understand and accept the boards' preliminary view that the scope of the proposed new lease accounting standard should be based on the scope of the existing standards. However, we believe that the existing exclusions of leases to explore or use natural resources and of licensing agreements should be removed.

In addition, we are of the view that the boards should also take this opportunity to incorporate the current guidance in IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease* into the revised standard on lease accounting.

<u>Question 2</u>

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.

We do not believe that non-core assets or short-term leases should be excluded from the scope of the new proposed standard. Such exclusion would replace one dichotomy (the split between operating and finance leases) with another. As explained in our response to Question 1, it is preferable to have a single model for lease accounting to reduce diversity in practice and structuring opportunities. While we understand that there are concerns about cost-effectiveness, we believe this is dealt with through the overlay of materiality in the application of IFRS, rather than a scope exclusion for items that, in aggregate, could be material.

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.

Broadly, we agree with the boards' analysis that in a simple lease such as that described in example 1 of the Discussion Paper, the right to use a leased item is an asset and the obligation to pay rentals is a liability.

However, some of our constituents have expressed their views that they consider that the analysis leading to the conclusion of existence of an asset and a liability is not adequate. For example, in order to meet the definition of an asset, the lease must arise out of a past event. These constituents 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.

On the concept of "present" obligation, these constituents consider the commitment to make a series of "future" rental payments does not fulfill the definition of "present" obligation, though there is an enforceable contract. They believe that on the signing of the lease contract, the lessor has unperformed service obligations and the rent is only payable on the condition that the leased item is being made available to the lessee.

Furthermore, they have concerns that the distinction between a lease and an executory contract is unclear.

We believe that to make the proposal more persuasive, the Discussion Paper should also provide further analysis to address the above concerns.

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. Appendix C describes some possible accounting approaches that were rejected by the boards.

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

We support the proposed approach and consider it can appropriately reflect the rights the lessee has acquired and the obligations it has assumed in respect of those rights. In addition, this approach will reduce structuring opportunities resulting in unrecognized financing for operating 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?

We think a components approach is conceptually a better approach as it is more consistent with the way that options and uncertainties are dealt with in other aspects of accounting. However, we are concerned about its practicability as the components approach would involve recognizing each of the options inherent in the lease in the statement of financial position and also the fair value of options to extend or terminate a lease is difficult to measure. We agree with the boards that the proposed approach is practical and also the information that is focusing on the expected cash outflows from the lease is useful for decision making.

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.

We support the proposed approach.

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.

We agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost. However, the boards should also clarify whether initial direct costs should be included in the right-of-use asset.

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.

We agree with an amortised cost-based approach to subsequent measurement of the obligation to pay rentals. However, we believe that subsequent measurement for the right-of-use asset should be consistent with the measurement of the underlying asset under its applicable accounting standards. By way of example, we believe that very long leases over land and buildings (eg 999 year leases) are substantially the same as freehold properties. The recent amendment to IAS 17 as part of the 2009 annual improvement project allows very long leases of own-use properties, and freehold properties, to be accounted for consistently; the revaluation model in IAS 16 may be applied in both cases. We support this amendment. However, we believe that requiring the right of use asset to be measured at amortised cost under a future IFRS for leases would be a backward step, which would again result in divergence in accounting for substantially equivalent assets. Accordingly, we propose that the entity should follow the accounting standard that is applicable to the underlying asset being leased. Therefore, a lessee would apply IAS 16, IAS 38, or IAS 40, respectively, if the underlying asset is property, plant or equipment; an intangible asset, or an investment property.

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.

We agree that a lessee should be permitted to elect to measure its obligation to pay rentals at fair value as fair value measurement reflects current market conditions. We believe it provides information that is more relevant than amortised cost to users of financial statements.

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.

We do not believe that the lessee should be required to revise its obligation to pay rentals for changes in the incremental borrowing rate. We support the argument in the Discussion paper that the proposal is inconsistent with an amortised cost-based approach to subsequent measurement. We do not believe that the liability would have highly variable cash flows and hence neither agree that a fair value based measure is appropriate nor do we believe this is consistent with the board's current direction for its proposed replacement of IAS 39. Finally we have concerns about the costs and the complexity for preparers.

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.

We support the boards' proposal to specify separately the required accounting for the obligation to pay rentals.

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.

We do not support this approach. We believe that the decrease in the value of the right-of-use asset should be presented as amortisation or depreciation expense in accordance with existing standards for PPE or intangible assets. We also note that rental expenses include an interest element and hence separation of the decrease in the value of the right of use asset from interest expense would be inappropriate if the intention were to be to disclose rental expenses in the statement of income.

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.

We do not support the proposed approach as this would result in the recognition of a liability to pay rentals that does not exist unless and until the option is exercised by the reporting entity. We do not believe that there is any present obligation arising in respect of the option, and hence the possible future rentals in the extended period do not meet the definition of a liability. The option, however, meets the definition of an asset and the premium for the option would have been included in the rentals for the initial period.

We recommend that only those renewal options for which there is no commercial likelihood of non-renewal and early-termination options that have no commercial effect in practice should be included as part of the lease term. In extreme cases, there will be no genuine commercial possibility that an option will fail to be exercised, in which case its future exercise should be assumed. For example, a transaction may be structured in such a way that the cost of exercising a renewal option will almost inevitably be lower than the benefits obtained from its exercise. In less extreme cases, further analysis will be required. It may be necessary to consider the true commercial objectives of the parties and the commercial rationale for the inclusion of such options in the transaction. This may reveal either that the parties in substance have outright obligations and access to benefits, or, alternatively, that the parties' obligations and access to benefits are genuinely optional or conditional. If the Boards agree with our proposal, additional guidance will be needed to determine how assessments of genuine options would be performed.

Alternatively, if the boards retain its proposal of recognising options when determining an obligation to pay rentals, we support the IASB's proposed approach to take into account the most likely lease term. The accounting under this approach would more closely reflect the expectations of management when deciding to undertake the lease and "most likely" is a concept that should not be too difficult to apply in practice.

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.

Following from our response in Question 13, we do not support the recognition of a liability for the option to extend the lease term, and hence we believe no reassessment of the lease term at each reporting date is necessary. However, if the board continues with its proposal to incorporate optional periods in the measurement of the liability, we believe that the entity should adjust the right of use asset for any adjustment arising from reassessments of the lease term.

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.

We agree that purchase options should be accounted for consistently with extension options because providing a purchase option is essentially the same as providing renewal that extends over the entire economic life of the lease. However, as noted in Question 13 we do not support the Board's proposed approach to the accounting for such options.

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?

We agree with the views of board members expressed in paragraph 7.12 of the Discussion Paper that contingent rentals linked to the performance of the asset should be treated differently from other variable payments (e.g. those linked to an index).

The most common example is turnover-based rents paid by retailers (e.g. in shopping arcades). As the mix of tenants and overall management of the arcade is outside the control of an individual retail unit lessee but can have a direct impact on the success of the individual retail unit, it is very common to have a significant portion of the rent being contingent on turnover. We consider that a payment that is linked to the performance of the lessee should be expensed as incurred and should not be accrued as estimated liabilities.

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.

As mentioned in Question 16, we do not support including contingent rental payments linked to the performance of the asset in the obligation. For the other variable payments, we support the approach of measuring the lessee's obligation to pay rentals on the basis of the most likely rental payment because it is simpler to apply than the probability–weighted approach and the resulting information is understandable.

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.

We support the proposed approach but we consider the lessee should measure the obligation to pay rentals using the relevant forward rate based on the yield curve at the inception of the lease for the time period closest to the lease term rather than a spot rate.

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.

We support the proposed approach. As noted in our response to Question 16, we do not believe that contingent rentals linked to the performance of the asset should be included in the liability to pay rentals. However, we support the proposed approach in respect of other forms of contingent rent.

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.

Based on our response in Question 16, we believe that only changes in estimated contingent rentals due to changes in indices or rates should be included in the measurement of the liability. Changes in these rentals should be recognised in profit and loss because such changes are not related to the value of the underlying leased asset. For example, if a lease obligation were remeasured for contingent rental payments associated with an interest rate increase, the increase in the lease obligation is not necessarily indicative of a change in the right of use asset or a better measurement of the right-of-use asset. Therefore, it is more appropriate to recognise those changes in profit or loss.

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?

We support the boards' decision that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same.

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?

The obligation to pay rentals is similar to a secured borrowing, and an entity should not be required to present its obligations to pay rentals separately in the statement of financial position. However, we would be in favour of a separate presentation in the notes to the financial statements.

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?

We support the boards' tentative conclusion that the right-of-use asset should be presented separately from own assets in the statement of financial position, on the basis of the nature of the leased item.

Question 24

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

We consider the project should also consider topics including accounting treatment for lease incentives, initial direct costs and lease modifications.

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.

We believe that a lessor's right to receive rentals under a lease meets the definition of an asset because it is a contractual right to receive payment from a 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.

We support approach (a) where the lessor derecognises the leased item and recognises a receivable (a financial asset) and a residual value asset (a non-financial asset). The lessor in effect has sold its right to use part of the leased item, being the entire asset for a portion of the lease term, and has in turn obtained a receivable from the lessee. However, we believe that the model adopted should be consistent with the direction the boards intend to take for both revenue recognition and derecognition of financial assets, and urge the board to consider lessor accounting in the light of decisions taken on those projects.

Question 27

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

We agree with the views in paragraph 10.28 that the boards should establish criteria to determine when income should be recognised at the start of a lease instead of trying to differentiate when the substance of the transaction is a purchase/sale.

Question 28

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

We do not believe that accounting for investment properties should be included within the scope of any proposed new standard on lessor accounting. While, from a conceptual standpoint, we would prefer all lessor accounting to be governed by one standard and based on the same principles, we share the view espoused in paragraph 10.48 of the Discussion Paper that replacing the lease item (i.e. the property) with two assets (a receivable and an interest in the residual value) is less relevant to users of financial statements.

Question 29

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

Except for issues identified in Question 28, we do not aware of any for the moment.