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

14 December 2010

Dear Sirs,

Re: IFRS Exposure Draft on Leases (ED/2010/9)

We would like to thank you for your invitation on commenting the Exposure Draft on Leases which was issued by the International Accounting Standard Board ("the Board") on 17 August 2010. Constant review on existing accounting standard helps to enhance the presentation of financial position and performance of an entity.

Esprit Holdings Limited and its subsidiaries are principally engaged in wholesale and retail distribution and licensing of quality fashion and lifestyle products internationally. Being part of the retail industry, our retail stores are run under operating leases. The proposal for a new accounting standard on lease accounting would definitely have a measurable impact on us. We sincerely appreciate the Board's effort on the preparation of the exposure draft in order to enhance the lease accounting. In the meantime, the proposed right-of-use model makes us hesitating on its consistency with the existing accounting standards since the proposed model does not necessarily improve reliability and comparability as many estimates are required in the measurement of assets and liabilities. Furthermore, the costs to implement the proposed model are significant to the preparers of financial statements.

Our concerns regarding the proposals in the exposure draft are set out below.

Recognition of assets and liabilities

The proposed model requires the lessee to recognize the right-of-use asset for all types of leases regardless of the fact there is no acquisition of assets in substance under certain types of leases. In general, a retailer is able to operate in a retail store by purchasing the store or entering into a lease of the store with the lessor. The decision to use the store premise under lease instead of purchase depends on various business reasons. When a retailer has determined to use the store premise under operating lease as defined in IAS 17, there is no commercial intention to acquire any assets at the inception of leases. Capitalization of assets does not reflect the real commercial purposes.
Under IAS 17, assets can be leased by either finance lease or operating lease. Leased assets under finance leases are recognized on the balance sheet while no asset is recognized in operating leases. It will be impossible to distinguish between operating lease and finance lease because the leased assets under all leases are recognized on balance sheet under the proposed model. This appears to neglect the fact that no asset is transferred to the lessee in substance under operating lease while the leased asset itself instead of the right-of-use asset is transferred to the lessee in substance under finance lease.

Regarding the measurement of right-of-use asset and liability to make lease payments under the proposed model, estimations about variables in relation to a long period of time after the commencement of lease have to be determined at the commencement of lease. However, significant uncertainties would definitely affect the reliability of information obtained. Forecasts are only based on the projection of past data and sudden changes in unpredictable macro economic environment would lead to invalidation of previous predictions. A significant degree of judgments is involved in the measurement of the right-of-use asset.

As such, we believe the right-of-use asset does not meet the definition of asset as we are not convinced that the amount of the right-of-use asset would be reliable.

For lessee, the liability to make lease payments under the proposed model does not meet the existing definition of a liability. Present obligation does not exist for expected payments of contingent rentals, term option penalties and residual value guarantees. We also believe there is no present obligation for rental payments beyond the non-cancellable lease term. What is more, the present obligation does not arise from past events which are not matching with the definition of liabilities. We do not believe the inception of lease represents a past event as the lessor still has obligations unperformed at that moment.

**Contingent rent increases the complexity and reliability of estimations**

Contingent rental arrangement based on a percentage of sales is common in the leases of retail stores. The amount of contingent rent is somehow hard to estimate as it also involves the estimation of sales based on a number of assumptions, e.g. prices, traffic etc. Especially when the operating lease period is long, e.g. over 5 years, it is difficult to accurately estimate the 5-year or more sales owing to the non-foreseeable economic fluctuations. This would significantly increase the difficulty and complexity for determining net present value for contingent rent and reduce the reliability of the amounts of both right-of-use asset and liability to make lease payments at the same time.
Renewal right increases the complexity and reliability of estimations

It is difficult to estimate the impact of renewal options on the lease term. The probabilities for the exercise of renewal options are affected by numerous external factors and some of them are out of control of the management, for example, the sudden change in macro economic condition and the change in management practices of lessor i.e. terms and conditions on operating lease. Leases renewals are also affected by sales performance and capital expenditure for the retail stores which are unknown at the inception of leases. These unpredictable factors create complications and estimations are not dependable with information obtained.

Impacts on financial ratios

The proposed model inflates both assets and liabilities in the balance sheet. This will distort the financial ratios, especially the leverage ratio by recognition of additional liabilities. Financial covenants as earlier determined in loan agreements with the bankers have the risk of being breached if the liability level increased. Once the values of financial ratios have been revised, re-negotiations on terms and conditions might be requested by financial institutions and banks and ultimately increases the costs of the borrowers. The change in ratio may affect behaviors of stakeholders and investors on how they review the performance of the business. As a retailer, the leverage ratios will be tied up with the number of retail stores according to proposed model. Leverage ratios will fluctuate throughout the period if stores keep opening or closing for strategic purposes and diminish investors’ confidence with constant changes in some ways.

Violation of the principle of matching of costs with revenues

The proposed model will result in higher total expenses (amortization expense on right-of-use asset plus interest expense on liability to make lease payment) in the earlier periods of a lease compared to the pattern for operating lease under IAS 17. The total expenses for each period will decrease over the lease term. This trend contradicts the trend of the inflow of economic benefits, which are the sales of retail stores in the case of retailers.

Costly as frequent review required

The proposed model requires reassessment of the liability to make lease payments. Extra time and costs would be incurred by taking external factors into considerations during the progress which include reassessment of the length of the longest possible terms, expected amount of contingent rentals, expected payments under term option penalties and residual value guarantees, and any changes on needs to adjust assets, liabilities, and profit or loss items. These extra efforts put pressures on the management and cause unnecessary administration costs burden especially to the retail industry which has entered into a large number of leases for the retail stores.
Recommendations

As there are concerns regarding the recognition and measurement of assets and liabilities in the right-of-use model as well as the additional costs required to adopt the proposed model, we would recommend that the Board to modify the existing IAS 17 to require additional disclosure regarding operating lease in the notes to financial statements rather than replacing with new standard. Additional quantitative and qualitative information for operating lease in relation to contingent rent and renewal option could be disclosed in details in order to provide adequate transparency to the public and stakeholders with less impact on the preparers of financial statements.

Thank you for taking our opinions into your considerations. It would be our pleasure to respond if there is any further discussion regarding to this submission. Please do not hesitate to contact me on fookaun.chew@esprit.com.

Yours faithfully,

Chew Fook Aun  
Group CFO  
Esprit Holdings Limited

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Esprit Holdings Limited and its subsidiaries are principally engaged in wholesale and retail distribution and licensing of quality fashion and lifestyle products designed under its own internationally-known Esprit brand name. The Group operates with 12 established product lines offering women’s wear, men’s wear, kid’s wear, edc youth as well as shoes and accessories in over 1,100 directly managed retail stores and over 12,000 controlled-space wholesale point-of-sales internationally. Esprit was listed on the Hong Kong Stock Exchange in 1993 and is a constituent stock of the Hang Seng Index, MSCI Hong Kong Index, FTSE All-World Index for Hong Kong, S&P/HKEx LargeCap Index and S&P Asia 50 Index.