20 December 2010

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

Dear Sirs,

IASB Exposure Draft
“Leases”

We welcome the opportunity to respond to the Exposure Draft issued by IASB.

We do not agree with the proposed new accounting model for leases and we have serious concerns on the proposed requirements, in particular, on recognition and measurement.

Whilst we acknowledge that under the existing model, there are circumstances where users of the financial statements make adjustments to reported balance sheet amounts to suit their needs, we believe that the proposed model will continue to necessitate that users make adjustments to reported amounts, particularly in relation to the income statement which we believe will become less relevant to most users. Given the existing, extensive disclosure requirements for leases, we believe that the requirements of users of the financial statements are already met. Consequently the proposed new leasing model is not necessary as it provides no meaningful, additional information to the users of the financial statements (and in some circumstances will provide less clarity), whilst introducing additional complexity and cost. Furthermore, if the proposed standard in its current form is to be adopted then we have serious concerns about its application in practice, particularly in relation to property leases in Asia.

A single model for lessee accounting is overly simplistic, not taking into consideration the real economic differences between different types of leases. The dual models for lessor accounting (depending on risks and benefits retained by the lessor) which the Boards maintain, illustrates well that one model of accounting does not work.
Instead of adopting a ‘one model for all leases’ approach for lessees and dual models for lessor accounting, we urge the Boards to maintain the current lease accounting model and focus instead on making changes to those areas which are of immediate concern to users such as providing an enhanced ‘bright line’ test to distinguish between operating and finance leases which we maintain have very different natures.

**Part 1: General Concerns**

The followings are the key areas of concern:

1. **The right-of-use model for lessees under all lease arrangements**

   The conceptual framework project, which included the revision and clarification of definitions and recognition of assets and liabilities, is still under development. We understand that the discussion papers for Phase B (Definition of elements, recognition and derecognition) and Phase C (Measurement) have not been published and the Boards do not expect to consider these phases until after June 2011. The Boards explain in BC7 (a) of the ED that the progress of individual projects (including the new lease model) should not wait until the conceptual framework project was completed as they consider that it is unlikely that any future developments in the conceptual framework project would cause the Boards to revise the definitions of assets and liabilities arising from leases. (As stated in BC6 (d), a right-of-use asset is a resource controlled by the lessee as a result of entering into a lease and from which future benefits are expected to flow to the lessee. The Boards believe that it meets the definition of an asset.)

   However, we are concerned by this approach especially when a sound definition on the notion of ‘control’ has not yet been developed under IFRS. Under the ED on Revenue from contracts with customers, the Boards proposed the use of the ‘control’ model to determine when a good or service is transferred to a customer. Certain indicators were proposed by the Boards which included the unconditional obligation to pay, the transfer of legal title, physical possession and the customer-specific design or function of the good or service. While this is a shift from the ‘risk and reward’ principle in the current accounting standards on Revenue, a comprehensive conceptual definition on ‘control’ has not been laid down in the ED.

   We consider that certain lease arrangements do not constitute a transfer of control of the underlying asset from the lessor to the lessee. In many cases, lease arrangements do not have any structuring or financing elements. The lease terms are short relative to the useful life of the asset. Under these types of leases, a lessee does not have legal title to, nor any control, of the underlying asset. The owner of the leased asset retains substantially the risks associated with the asset and is entitled to most of the future benefits of the asset including its residual value. During the lease term, the lessee has an obligation to pay rent to the owner as it receives economic benefit from the use of the asset. The lessor, on the other hand, has the obligation to maintain the underlying asset in good condition and to ensure proper management of the asset for the use of the lessee throughout the lease period.

   Therefore, it is not appropriate to recognize a right-of-use asset and a right-to-receive asset, as well as the corresponding lease obligations, in the balance sheets of the
lessee and lessor (under the performance obligation approach) respectively at the inception of the lease. Instead, both parties should recognize their respective lease expense and income as they fulfill their respective obligations during the lease period.

This type of arrangement is very different from a lease which is merely a financing arrangement of a sale and purchase transaction in substance, where the lessee enjoys all or most of the benefits and bears all or most of the risks from owning the asset. To account for these two types of arrangement using the same model will not lead to the fair representation of the underlying transactions. Such is the real difference in economic substance between operating and finance leases, as generally defined by current standards that if all leases were treated in a similar fashion, we are convinced that many users of the financial statements would seek to adjust the financial statements, the balance sheet and particularly the profit and loss statement, to eliminate the impact of the proposed new standard.

We use a retail company in Hong Kong as an example. It is generally not the intention of retailers to own the properties in which their retail outlets are located nor to manage the risks associated with property investment. Instead, a retailer will enter leases with a fixed term of between three to five years. This enables retailers to limit their fixed costs in the face of uncertain revenues from any given location and to focus on their core competency, retailing. There is no financing element in these lease arrangements as the residual risks and benefits of the retail property rest with the lessors. As a lessee of a retail property in Hong Kong, there is limited capacity to influence or control the leased property. In fact, it is quite common that there are certain restrictions imposed by lessors, for example, covering the nature of business conducted and requirements on fit-out and renovation. For a leased retail outlet in a shopping mall, the lessee has the responsibility to properly manage the quality of the mall and stores within it as well as the tenant mix to attract traffic. On this basis, this ‘operating’ type of lease arrangement does not meet the criteria of transfer of control. Therefore, an asset should not be recognized in the balance sheets of both the lessee and lessor.

In addition to the lack of a strong conceptual basis for the “right-of-use” model, there is an inconsistency in the proposed approach between lessee and lessor accounting notwithstanding the Boards’ explanation of the decision to use the two different models for lessors in BC23 – 27.

The Boards recognize that a lessor’s business model can indicate when a derecognition or a performance obligation approach will be appropriate (BC27(a)-(b)). The derecognition approach is likely to be appropriate when the lessor’s business model is primarily the provision of finance and its principal business risk is credit risk. The performance obligation approach is likely to be appropriate when the lessor’s business model is primarily a return from active management of the asset from leasing it to multiple lessees. In this case, the principal business risk is asset risk. We consider that a consistent or symmetrical approach for both lessee and lessor accounting should be adopted. This would be better, both conceptually and practically.

2. Requirement of significant management judgments and estimates

Rather than simplifying lease accounting to improve financial reporting, the ED introduces more complexities and uncertainties in application. The ED requires significant management judgments and estimates in measuring the present value of lease payments, on inception and throughout the lease period, including the use of
discount rates, the expected outcome approach in determining the lease term (fixed term and renewal options), and contingent rents. Such subjectivity will distort, rather than improve, the comparability of financial statements among reporting entities.

We are also concerned with the undue burden put on management to ensure the reliable estimation of lease payments. It would seem difficult if not impossible even for an experienced retailer to forecast sales (to calculate sales-linked contingent rent) over the expected lease term (which could be up to 10 to 15 years based on the definition under the new model) for a portfolio of stores. The budgeting timeframe for most companies especially in the retail business would normally be 3 to 5 years. With a dynamic and volatile business environment, any longer term business projections could well be unreliable. Certainly the additional expense incurred by this process would far outweigh the benefits of it.

3. Distortion of financial parameters

Upon implementation of the proposed amendments to the standards, many entities’ bank covenants will be significantly affected with the level of financial liabilities being increased. This form of liability would generally not have been contemplated at the time when the bank covenants were agreed. Gearing ratios and EBITDA and PBIT measurements (with existing rental payments replaced by the lease amortization charge and financing charge on lease liability) will be distorted.

For the retail industry, the key ratios used by the investing community are mainly EBITDA which serves as a proxy for the cash flow generated from the business and PBIT to sales. Our experience indicates that if adjustments are made to the reported financial information by users such as analysts, it is to strip out the impact of accounting adjustments to focus on actual cash flow. The ED proposals would make this harder rather than easier to do. They create a wider difference between accounting income and cash flow from operations.

Part 2: Specific Concerns on Proposed Requirements

In addition to our disagreement with the proposed new lease model, we have specific concerns over the following proposed requirements should the new standards be adopted:

1. Measurement of lease payments

1.1. Initial measurement -

- Lease term: Longest possible term that is more likely than not to occur
- Contingent rentals (Expected outcome approach)

The lease term should not include any renewal option unless the lessee has a contractual obligation to renew. There are two issues. A renewal option exercisable by a lessee does not create any financial obligation until exercised. Where the lessee is able to avoid the contingent lease payments by choosing not to renew then the renewal option should not be accounted for as if it were exercised, which is the same as the treatment for other options in financial accounting. Also, we do not believe that a lease term beyond the initial term can be
reasonably and reliably estimated at the inception of the lease which is bound to
give rise to a lack of comparability between different entities' accounts.

For example, there are many factors affecting the decision to renew a property
lease of a retail business in a shopping mall. These include the landlord’s
management, the ongoing positioning of the mall and changes in consumer
demographics in the catchment area of the mall. In a dynamic market environment,
such as those existing throughout Asia, predicting whether a lease will be renewed
(if at the lessees' option) is very difficult and subjective. In addition, if the renewed
rental payment upon exercise of the option must be based on the market rent
expected to be prevailing at that time, this would involve significant, subjective
estimates especially in the case of Hong Kong where rental levels are volatile.

For similar reasons, we do not believe lease obligations should include contingent
rentals. Contingent rentals are defined in the ED as 'lease payments that arise
under the contractual terms of a lease because of changes in facts or
circumstances occurring after the date of inception of the lease other than the
passage of time'. The lessee does not have a present obligation to pay contingent
rentals at the inception of the lease until the occurrence of future outcome. The
future outcome is some level of revenue. Recognising a contingent liability while
ignoring that revenue have to have occurred at a certain level will create
confusion for the users of the financial statements. Also part of the risk of the
contingent portion of the lease is retained by the lessor. To illustrate, for contingent
rent linked to sales in a typical retail lease, the lessor has the responsibility to
maintain a good quality facility and an appropriate tenant mix to attract shoppers.

As a result, we consider that the current treatment, to recognise contingent rental
expense in the profit and loss account in the period as it incurs, remains more
appropriate to that proposed.

We observe that the requirements on the measurement of lease obligations are not
consistent with the existing standards on recognition of a liability. These require
that a present obligation must be as a result of a past event and that the obligation
can be reliably estimated. The ED, which proposes an expected outcome
approach (probability-weighted model) instead of a most likely outcome approach,
would necessitate additional subjectivity. This would give rise to a lack of
comparability between different entities' accounts. This would also give rise to
assets and liabilities whose value were determined on a very different basis to
other assets and liabilities.

Should the ED be adopted, we believe that the measurement of lease obligations
should only take into account the lease term and minimum lease payments to
which the lessee is contractually committed.

1.2. Subsequent measurement -
- Lease liability at amortised cost using the effective interest method
- Amortization of right-of-use asset over the lease term or useful life of the
  underlying asset if shorter

Under the proposed lease accounting model, the lease expense will be 'front-
loaded' due to the required amortization of leased assets and financing charge on
the notional liability. This accelerated recognition of the expense in early years
creates a mismatch between the cost and the economic benefit of a lease transaction. Indeed generally, it is expected that the economic benefits will typically increase over the lease term. For example, from our experience, revenue of a retail shop generally increases in line with the step-up in rents over time.

The current lease accounting which recognizes expenses relating to operating leases on a straight line basis, we consider better reflects the substance of most lease arrangements.

2. Reassessment of lease liabilities throughout the term of the lease

Similar to our concern on the initial measurement of lease liabilities, we believe the proposed amendments will increase unnecessarily the volatility of earnings, and reported assets and liabilities of the lessees as a result of the requirements to take into account changes in lease term and contingent rents in the measurements. At the time of lease renewal or cross-over to a new lease, significant fluctuations in the expense and associated liability may arise. We disagree that this attempt at greater precision will add to the understanding of the users of the financial statements.

3. Lessee’s incremental borrowing rates

Under the ED, a lessee shall measure the lease liability at the present value of the lease payments discounted using the lessee's incremental borrowing rate. An entity with a strong credit profile may have a lower borrowing rate and may end up with a higher lease liability when compared with a company with a weaker credit rating in the same transaction. This is counter-intuitive and creates unnecessary distortion of the performance and financial position of companies and detracts from comparability.

The ED has not addressed how to derive the discount rate for cash rich entities (i.e., those with no debt).

4. Scope

In the ED, there is no exemption for short term leases (i.e., with terms of twelve months or less) with the exception that a lessee can ignore the discounting effect upon recognition of lease obligations. Leases related to assets that are not essential to the operations of an entity, which the ED refers to as “non-core” assets, are also within the ED’s scope. Common examples of these types of leases are rental of photocopiers, cars for employees, office space and staff quarters.

While we understand the rationale for this as set-out in BC39-40 of the ED, substantial efforts would be required for compliance with the ED, while the information is likely to be of little value or relevance to users, for many of the reasons outlined above.

Part 3: Effective Date and Transition

If the Boards proceed with the implementation of the ED, we would agree with the proposed simplified retrospective method for transition which is practical and less onerous
especially for those entities with a large number of lease arrangements. An extended lead time for the introduction of the proposed standards would also enable sufficient time for entities to make necessary changes to their relevant systems and operational processes.

If you have any questions on the content of this letter, please do not hesitate to contact me.

Yours sincerely,

[Signature]

James Riley
Group Finance Director

c.c. Hong Kong Institute of Certified Public Accountants

About the Jardine Matheson Group

Founded as a trading company in China in 1832, Jardine Matheson is today a diversified business group focused principally on Asia. Its interests include Jardine Pacific, Jardine Motors, Jardine Lloyd Thompson, Hong Kong Land, Dairy Farm, Mandarin Oriental, Jardine Cycle & Carriage and Astra. These companies are leaders in the fields of engineering and construction, transport services, insurance broking, property selling, restaurants, luxury hotels, motor vehicles and related activities, financial services, heavy equipment, mining and agribusiness. The Group had revenues (including the revenues of associates and joint ventures) of US$36 billion in 2009 and total assets of almost US$40 billion at the end of 2009. It employs some 270,000 people.

Jardine Matheson Holdings Limited is incorporated in Bermuda and has a premium listing on the London Stock Exchange, with secondary listings in Bermuda and Singapore.

Jardine Matheson is one of the pioneers in adopting International Financial Reporting Standards, having first prepared its financial statements in accordance with IFRS in 1990.