

Response Letter to the Exposure Draft: *Leases*

From China Telecom

To International Accounting Standards Board (the "Board")

We have read the revised Exposure Draft: *Leases* issued by the Board on 16 May 2013. We thought that the Exposure Draft resolved the question raised by many accounting standard users regarding off-balance sheet accounting for operating lease. However, the Exposure Draft classifies a lease as either a Type A lease or a Type B lease according to whether the underlying asset is property or not. This is much more complicated than the current classification of operating lease and finance lease. For lessors and lessees, the Exposure Draft provides two different sets of accounting treatments, whose principles are still based on the current accounting treatments of operating lease and finance lease, but are much more complicated than the current ones. It is difficult to understand, apply and implement the standard. Moreover, the asymmetrical accounting treatments for lessor and lessee are logically unsound.

We thought that the accounting treatment of lessee accounting for finance lease under the current standard is appropriate. It basically fulfills the need of users of financial statements. However, the accounting treatment for Type A lease in the Exposure Draft is too complicated. We thought that such accounting treatment is not practical for accounting staff. We suggest that the Board continues to adopt the lessee accounting treatment for finance lease under the current standard.

We thought that the lessor accounting under the current standard is appropriate, furthermore the operating lease method is retained in the Exposure Draft for the lessee accounting. Therefore, we suggest that the Board continues to adopt the lessor accounting under the current standard, and add more disclosures requirement to fulfill the need of users of financial statements based on current IAS 17.

We hope that the Board thoroughly considers the practicability of the standard and simplify the content of the Exposure Draft so as to truly improve the current lease standard. Our responses are as follows.

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration”. An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Response:

Basically we agree with the definition of lease in the Exposure Draft. We hope that the Board further clarifies the difference between lease and hire purchase (the nominal ownership right is transferred at the end of the last payment period, but in substance, the asset is controlled and used by the user throughout its entire life cycle).

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

We agree with the Exposure Draft to account for operating lease in the balance sheet through right-of-use model. However, the accounting treatments of classifying property into Type A and Type B, and classifying non-property into Type A and Type B in the Exposure Draft is too complicated. It is too difficult for accounting staff to apply, so we do not agree with this classification.

We thought that classifying the lessee into Type A and Type B does not give users of financial statements more relevant information. We thought that when operating lease is accounted for in the balance sheet, the need of users of financial statements can be fulfilled. Therefore, we suggest that the Board does not differentiate Type A lease and Type B lease. Type B lease should also adopt the same method of accounting as Type A lease. The right-of-use asset should also be amortized using the straight line method.

If it is necessary to differentiate Type A lease and Type B lease, when reassess the lease term, it may be necessary to reassess the classification of the lease. This is

because an entity may take into account its business development and in turn, change its mind to substantially extend or shorten the lease term. This may result in a significant difference from the original lease classification.

Type B lease separately accounts for lease expense, interest expense and amortization expense, but the amortization expense and interest expense are combined in presentation. This violates the requirement of consistency between the financial record and financial statements.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

We do not agree with the lessor accounting in the Exposure Draft. We suggest that the lessor continues to adopt the requirements of the current lease standard.

In the receivable and residual model of the Exposure draft, the estimation of the fair value and expected residual value of the leased asset is too subjective. Moreover, the estimated value will change over time, and, in turn, resulting in a change in the residual asset. This will result in more complicated accounting treatments. Such complicated accounting treatments cannot provide users of financial statements more useful information, and does not fulfill the cost-benefit principle of accounting standard setting.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response:

We do not agree with the classification of lease. Even though the Exposure Draft classifies leases in accordance with whether the underlying asset is property or not, but it requires that underlying asset which is not property can also be classified as Type B lease when certain criteria are met. Property which meets certain criteria can also be classified as Type A lease. The criteria for making the judgment are too complicated, not straight forward, and are not convenient for implementation.

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response:

We thought that the concept of "significant economic incentive" related to lease term in the Exposure Draft is quite subjective. The judgment made by lessee and lessor is likely to be different. For example, once a telecom company leases a computer room and finishes setting up the respective facilities, which involve a series of complementary facilities such as telecommunications facilities and pipe lines, the cost of modification is significant, so the telecom company rarely makes changes. However, the lessor does not necessarily understand the interests involved; therefore, the lessor may make a different judgment from the lessee.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Response:

In general, we agree with the requirement that the lease payment calculated based on an index or a rate should be re-measured at the end of the reporting period. In the meantime, we suggest that the Board gives a criterion for materiality. For example, if the interest rate changes by more than 20%, the lease payment should be re-measured. If the change is less than the materiality level, the lease payment does not need to be re-measured. This decreases the risk of accounting error during the adjustment and the cost of implementing the standard.

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

Response:

We do not agree with the proposal for retrospective adjustment. We suggest that the Board provides more transition methods for entities to choose from.

The historical data of the Company are huge. It is estimated that more than ten thousand items are retained. Technically, it is difficult to recognize and re-measure the retrospective adjustment, and the cost of implementation is high. We suggest that the new standard is only applied to leases newly added during the period when the new standard is first effective and the subsequent periods. Leases for prior years are not retrospectively adjusted.

If retrospective adjustment is necessary, we suggest that only significant lease contracts are retrospectively adjusted. The number of lease contracts with small contract amount is exempted.

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response:

We do not agree with the disclosure requirement stated in the Exposure Draft. In general, the requirements are too complicated and too detailed. These requirements increase the difficulties and costs of entities to implement the new standard. For ordinary users of financial statements, who do not timely update their accounting knowledge like an accounting officer, such complicated disclosure requirements may result in misunderstanding or ordinary users of financial statements may even ignore the new disclosures. Such result does not comply with the intention of the standard and the cost-benefit principle.

Question 12 (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an

operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Response:

We agree that if the leased property meets the definition of investment property, the requirement of the investment property standard should apply.

China Telecom

Company information:

Name: China Telecom Corporation Limited

New York Stock Exchange stock code: CHA

Market capitalization as at 31 December 2012: USD 45 billion