International Accounting Standards Board
30 Cannon Street
London, EC4N 6XH
United Kingdom

13 September 2013

Dear Sirs,

IASB Exposure Draft on Leases issued in May 2013 (“Exposure Draft” or "ED")

I have completed my review of the Exposure Draft and my views are set out below.

I appreciate the time and effort taken by the IASB in developing the ED and the outreach activities that it has carried out. However, if the proposals are implemented I believe they will not produce the desired outcome. In fact, I suspect that there will be greater divergence and inconsistencies in practice such that readers of financial statements will find it even more difficult to understand the information presented to them.

I attended the 7th IFRS Regional Policy Forum held in Hong Kong in June this year. Mr. David Webb, who was a guest speaker at the conference and who is also a notable investor advocate in Hong Kong, indicated that there should not be any significant changes to the current leasing standard. I have a similar view and believe that the current disclosures of the annual rental expense and future lease payments by yearly bands, together with disclosures on the basis of computing any variable rents where applicable, provide more useful information of the true cash outflows arising from lease contracts.

I strongly believe the Board should defer any further significant work on the Exposure Draft. It should re-consider in detail the new conceptual issues raised in the ED’s proposals and their implications on the accounting for other contracted commitments. In particular, the new concept of right-to-use which divides a single physical asset into a bundle of rights to the economic resource or its service potential requires a detailed conceptual debate. Importantly, the ED fails to highlight sufficiently enough the implications of the fact that the lessor and lessee are in fact both using the same asset simultaneously in their business operations - the lessor to generate rental income whilst the lessee’s use results in rental payments which contribute to the running costs of the lessee’s business.

In response to calls for an urgent need to look at key concepts prior to making further revisions or amendments to existing standards, in July 2013 the IASB issued a discussion paper on A Review of...
the Conceptual Framework for Financial Reporting. I believe this should take priority over work on
the proposed revisions to the leasing standard. I strongly urge that work on the Exposure Draft be
deferred until the Conceptual Framework review is completed.

If completion of the Conceptual Framework project provides a clear indication that substantial
changes in the leasing standard is warranted, then the Exposure Draft should be revisited as it will
then be done with the benefit of a clear understanding of the conceptual aspects. I understand
others have strong dissenting views or concerns on the ED’s proposals and to proceed before they
are fully considered and properly addressed would be unwise. I note in particular that the proposals
in the Exposure Draft were not unanimously agreed to by all IASB members and four members of the
FASB also had dissenting views on the American equivalent.

My concerns are discussed below and where appropriate these include comments on where I
believe further work and re-consideration is necessary.

Rules-based rather than principle-based - adding to complexity

The ED is unduly complex and rather than providing clear guiding principles that can be applied
universally to all leased assets, the proposed requirements are in fact rules-based. Moreover, the
proposed rules are often modified by exceptions and in particular different rules will apply
depending on whether the leased asset is real estate, such as retail or office space (that is, a lease
classified as a Type B lease) or a non-real estate asset (a lease classified as a Type A lease).

I believe that implementing the proposals will add unwarranted complexity to financial statements
and as a result will make them more difficult to understand and therefore will be less useful to
readers. The function of accounting should be to serve the readers of financial statements and such
statements should be in a form that is easily comprehensible. In this respect, in my opinion, the
benchmark for a reader should be an ordinary lay shareholder and not a professional accountant or
professional investor.

One of the main purposes of financial statements is to inform and to enable readers to assess a
reporting entity's future cash flows. The current standard for leases achieves this by indicating
clearly and simply the yearly rental outflows charged through the income statement and the
disclosure of annual lease commitments that will be incurred in future years for operating leases.

I believe that the primary focus of financial statements should be to record “actual transactions”
that faithfully reflect the entity’s true cash inflows and outflows. I am very concerned that the
proposals lack simplicity in conveying relevant, reliable and faithful information. For example, under
the proposals for leases classified as Type A leases the rental expense will be replaced by two
elements; amortisation of the hypothetically determined “right-to-use” asset and an interest
expense. This information will not reflect the real cash flows of the entity. Type B leases will be
treated differently with a single rental expense charge. The proposed dual approach is an indication
that there is a conceptual issue that has not been satisfactorily resolved. I believe the proposals will
facilitate structuring of leases and the easier manipulation of the results and financial position of
reporting entities.
Costs of implementation will outweigh the perceived benefits

Although I agree with the objective of promoting greater consistency in accounting practice, I believe the proposals in the Exposure Draft will add unwarranted cost to preparers and especially listed companies which are required to report more frequently than just once a year. Financial ratios specified in the Hong Kong Listing Rules, which are based on the amounts shown in a reporting entity’s financial statements, would change significantly. I believe the cost of producing and maintaining the required information to comply with the requirements of the ED will outweigh the perceived benefits.

Fundamental issue

I believe the underlying fundamental concern and objective which the IASB is trying to address for lease accounting is to ensure that all leases which are in fact “finance leases” as defined under IAS 17, which are regarded as in substance the purchase of assets, are recognised as assets in the financial statements of lessees. However the proposals effectively treat all leases as being finance leases.

At this point I would also like to comment that not all leases and especially short term leases, which include leases for up to two to three years, are not entered into for the purpose of financing the purchase of an asset. There are many reasons other than financing for entering into a lease by a lessee and these include:

- avoid the tie up of capital
- the leased asset is only needed for the short term such as specialised equipment
- avoiding a long term commitment
- reduce the risk of obsolescence
- tax advantages

The ED attempts to reduce opportunities for structuring leases to achieve a desired outcome but I believe such opportunities will always be sought after. Due to its rules-based nature, the proposals are likely to increase opportunities for structuring.

I believe the crux or the real issue the ED is attempting to deal with is the issue of asset recognition/de-recognition and a clear principle should be established. Although this will be dealt with in the project to review the Conceptual Framework I believe it will be useful to mention it here. I believe the principle for the recognition and de-recognition of assets could be phrased along the following lines:

Where a party obtains in substance effective ownership of an asset and bears the risks and rewards of ownership, and accordingly possesses "control" over the asset, that asset should be recognised by that party. Similarly, where a party has in substance sold/ transferred effective ownership of an asset to another party, the asset should be derecognised. If consideration has not been paid for the
sale/transfer, the asset is replaced with a receivable representing the consideration receivable for the original asset that has been sold/transfered.

The above principle is a wide and general guiding principle and would not be restricted to lease contracts but would apply when considering accounting for all transactions made between two or more contracting parties.

I discuss further below, under the heading of "The Right-to-use - Is it an asset?, how I believe the term "control " should be interpreted in the general principle set out above which should also be how the term "control" in the definition of an "asset" in the current Conceptual Framework should be interpreted.

I would like to take the opportunity to mention here that some listed companies in Hong Kong acquire effective ownership and therefore control of assets by means of a contract with the legal owners as in certain jurisdictions legal ownership of assets located in the jurisdiction is restricted to individuals or parties resident in the jurisdiction. These listed companies therefore recognise such assets in their financial statements.

Another conceptual issue the ED touches on is whether a lessee, who does not own or have any equity interest in the asset, can be regarded as a simultaneous consumer and owner of the leased asset with the lessor. This is further discussed below under the heading of "The Right-to-use - Is it an asset?"

The meaning of a "lease"

Page 8 of the ED states the following:

"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."

I believe the above guidance could be improved and should address the following:

(a) Fulfilment of the lease contract does not depend on the use of the asset by the lessee. Rental payments under a lease contract would be payable on the due dates irrespective of whether the asset is being used (e.g. a tenant may decide not to use a flat he has rented as he has relocated elsewhere).

(b) An inherent characteristic of a lease contract is that it is time-based and I believe a time-based contract adds support a lease contract being an executory contract. This is discussed further below under the heading "A lease is time-based and is an executory contract".

(c) The right to control the use of the asset by the lessee is limited and importantly the limitation is imposed by the lessor. It is necessary to distinguish the level or extent of control a party holds. For example, the party that has effective ownership rights to the asset (namely, the lessor) has a degree
of control that is significantly different from the control rights available to the lessee. This is discussed further below under the heading "The Right-to-use - Is it an asset?".

(d) The definition refers to rights to use the "underlying asset" so it seems the right is inseparable from the underlying asset. One must not lose sight of the fact that under a lease contract the underlying asset is in fact being used by both the lessor and the lessee simultaneously.

In my view, a "true lease" would be one where it is neither intended, contemplated or reasonable to assume that the lessee will ultimately take title to or become the effective owner of the leased asset.

My comments below are primarily directed at these "true leases" and not "finance leases" which are in substance contracts for the purchase of an asset.

The Right-to-use - Is it an asset?

The ED introduces the idea that a lease creates a right-to-use and the position taken is that this right represents an asset that should be recognised. I understand that the idea of a right-to-use is not new and has been around in accounting literature for many years. However, wide agreement that such rights are in fact assets has yet to be reached and I believe this is because the issue has not been discussed in the right forum, that is, it has not been fully discussed at the conceptual level.

I have significant concerns that the Exposure Draft’s proposals are inconsistent with the current interpretation of what is normally regarded as an asset. Although the ED attempts to address compliance with the definition of an asset included in the current Conceptual Framework, I believe the analysis is too brief and does not consider in enough depth how the definition is interpreted and applied in practice.

I believe that a lease contract does not create an asset as proposed under the ED immediately when the asset is made available to the lessee at the commencement of the lease. My reasons for this opinion are discussed below.

Paragraphs BC13 and BC14 of the Basis for Conclusions states the following to support the IASB’s view that the right-to-use is an asset.

"BC13 The IASB’s Conceptual Framework for Financial Reporting (Conceptual Framework) defines an asset as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.” FASB Concepts Statement No. 6, Elements of Financial Statements, states that “[a]ssets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” The main characteristics of both definitions of an asset are that the entity controls an economic resource or benefit, the resource or benefit arises from a past event and future economic benefits are expected to flow to the entity. The boards concluded that a lessee’s right to use the underlying asset meets the definition of an asset for the following reasons:
(a) the lessee controls the right to use the underlying asset during the lease term because the lessor is unable to have access to the resource without the consent of the lessee (or breach of contract). Once the asset is delivered, the lessor is unable to retrieve or otherwise use the underlying asset during the lease term, despite being the legal owner of the underlying asset.

(b) the lessee’s control of the right of use is also demonstrated by its ability to determine how and when it uses the underlying asset and, thus, how it generates future economic benefits from that right of use. For example, assume a lessee leases a truck for four years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period of time that the truck is driven by the lessee. Upon delivery of the truck to the lessee, the lessee can decide how it wishes to use up or consume the economic benefits embedded in its right of use. It could decide to drive the truck constantly during the first two years of the lease, using up all of the economic benefits in those first two years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.

(c) in some leases, a lessee’s right to use an asset includes some restrictions on its use. For example, in the truck example in (b) above, the lessee cannot drive the truck for more than 160,000 miles over the four-year lease term. Some may think that those restrictions result in the lessee not having control of the right to use the underlying asset. However, the boards have concluded that, although those restrictions may affect the value of and payments for the right-of-use asset, they do not affect the recognition of the right-of-use asset. That is consistent with the recognition of other assets. It is not unusual for particular restrictions to be placed on the use of owned assets as well as leased assets. For example, assets that are used as security for particular borrowings may have restrictions placed on their use by the lender, or a government may place restrictions on the use or transfer of assets in a particular region for environmental or security reasons. Those restrictions do not necessarily result in the owner of such assets losing control of those assets—the restrictions may simply affect the economic benefits that will flow to the entity from the asset and that will be reflected in the price that the entity is willing to pay for those economic benefits.

(d) the lessee’s control of the right of use arises from a past event—the signing of the lease and the underlying asset being made available for use by the lessee. Some have suggested that the lessee’s right to use an asset is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the asset (which is similar to the situation that would arise if an entity failed to make payments on an instalment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the underlying asset.
Consequently, the boards concluded that the lessee’s right to use the underlying asset meets the definition of an asset in the IASB’s Conceptual Framework and in Concepts Statement 6."

With due respect I disagree with the IASB’s analysis. My first concern relates to how the term "control" used in the definition of an asset in the Conceptual Framework has been interpreted and my second concern relates to the proposed notion of consumption and how it is used.

Concerns on how "control" is interpreted

I believe the word "control" has been interpreted too liberally by the IASB to justify asset recognition.

Although the current Conceptual Framework defines an “asset” as “a resource controlled by the entity arising from past events and from which future economic benefits are expected to flow to the entity”, I believe the essential characteristic of an asset is that its holder must possess the risks and rewards of ownership and as a consequence this will be accompanied by control over the item. Control per se is insufficient. It is necessary to assess the nature and extent of the control.

Control by an owner does not merely include control on how the asset is used but also includes the power to unilaterally sell the asset, pledge the asset as security for a loan, and to destroy and write off the asset. In contrast, the ability of the lessee to control is limited and more importantly this limitation of control by the lessee is imposed by the lessor. The IASB’s reasons (b) and (c) above show the power of the lessor’s restrictions imposed on the lessee.

To illustrate we can look at a common situation in Hong Kong where a taxi driver leases a taxi from a taxi company. Based on the reasoning included in the ED it could be argued that the taxi driver controls a resource (namely the taxi that he drives), and as he will obtain economic benefits from his control of the taxi the driver should regard the taxi as his asset. Common logic however would say no to this argument as clearly the resource is only an asset of the taxi company. The control over the taxi by the taxi driver is significantly different from the control over the taxi possessed by the taxi company. The distinguishing feature is that the taxi company’s control over the taxi is much broader than the control held by the driver. The taxi company has ultimate control of the taxi but the taxi driver’s control is limited to using the taxi as prescribed by the taxi company.

In my view the right to use an asset is inseparable from the underlying asset and this is in fact reflected in the definition of a lease and the reasoning of the IASB mentioned above. They are the same thing. The key issue then is on the question of when an asset can be recognised. Do you consider the party who has complete control over the whole physical asset (the lessor) or should you consider the claims of the borrower of the asset (the lessee) who has partial and limited control over the asset.

I would agree that a leased asset is a resource used by the lessee but I believe a lease is an executory contract and this is further discussed under the heading of "A lease contract is time-based and is an executory contract" below.
Moreover the resource, which is made available to the lessee, by itself will not always provide economic benefits to the lessee. On the contrary, rather than economic benefits, use of the resource by the lessee will contribute to his operation costs. The resource will only produce economic benefits if the use of the underlying asset together with the sale of other goods and services produces revenue that exceeds the rental payments and other operating costs. In other words, the right-to-use first and foremost creates obligations and costs and does not produce economic benefits in its own right. Economic benefits only arise from ancillary revenue generating activities.

In addition, on their initial recognition and prior to any re-measurement for impairment or adjustment for fair value (which is another conceptual issue in its own right) the characteristic of all assets held by a reporting entity is that they essentially fall under one of the following two categories:

(a) an expense that has been incurred but where there is justification that the expense can be capitalised and deferred. (e.g. inventories, investments, fixed assets and prepayments); OR

(b) a receivable (e.g. trade debtors, loans receivable, amounts due from banks including cash in hand as cash too is effectively promises to pay by the note issuing banks or governments). These assets often represent the conversions of other assets previously held.

An exception would be a "finance lease" where an asset is recognised. However this asset is recognised on the premise that the substance of the transaction is a purchase and there has been the transfer of effective ownership rights of the leased asset from the lessor to the lessee. Another exception to the above would be the recognition of deferred tax benefit assets but the issue of deferred tax is substantial debate in itself and I understand that the IASB intends to review deferred tax accounting in due course.

I would point out that a "right-to-use" does not fall into any of the above two categories and accordingly they should not be regarded as assets. Moreover, dissimilar to a "finance lease" as defined under IAS 17, a lease classified as Type A lease under the ED, only requires the consumption of more than an insignificant portion of the economic life of the underlying asset and in the case of Type B leases, the lease can be for an insignificant portion of the economic life of the underlying asset. The right-to-use is regarded as an asset solely on the basis that there is a right but I would stress that the right only provides just some but limited control over the underlying asset.

In summary, I believe a lessee does not have ownership control to do whatever he likes with the leased item. A lessee does not have true control but only has temporary access to the leased item.

**Concerns on the proposed notion of "consumption" and how it is used**

I believe a major omission in the ED is a discussion that in the act of leasing an asset to the lessee the lessor is in fact also consuming or using the asset. The lessor and lessee are both consuming or using the same asset simultaneously. Both the lessor and lessee are making use of the same asset in their businesses - the lessor is using the leased asset to generate rental income whilst the lessee's rental payments for the use of the same asset contribute to the running costs of the lessee's business.
As mentioned above the right-to-use is inseparable from the underlying asset. The question then is this. *When two parties consume or use the same asset at the same time what are the implications on their accounting? Where the asset in question is the same thing who can recognise the asset- can two parties recognise the same asset at the same time, and in particular when the underlying asset has not been sold?*

In my view, the only party that can recognise an asset is the one that has effective ownership of the asset, namely, it has to be the lessor who has made a cash outlay for the asset. As mentioned above I believe the right-to-use is not an asset as it does not have the characteristic of an asset, i.e. it not a expense that has been capitalised nor is it a receivable.

I believe a major omission of the ED is that fails to recognise that in a lease contract, the lessor still retains effective ownership and therefore effective control over the underlying physical asset. The lessor has not sold the asset. Under IAS 17 the reason for separately identifying "finance leases" from "operating leases" is to identify leases which in substance are purchases of assets. Finance leases are in substance purchases of assets and these are accounted for as assets of the lessee as the lessee has acquired effective ownership of the asset through the lease contract.

In my view, the term "use" should be distinguished from the term "consume" and a distinguishing principle could be that you cannot consume anything that you do not in substance own. The two very similar terms can be differentiated on the basis of who possesses the risks and rewards of ownership (e.g. one can use a taxi but the taxi company that owns the taxi is consuming the asset). Ownership, whether legal ownership or effectively obtained by contract, would be key.

The lessee's use of the leased asset is solely dependent on the lessor. Use by the lessee of the leased asset is only made possible if the lessor chooses to lease the asset to him. Without the existence of the lessor and his asset, the lessee cannot be a user of the asset. This leads to my conclusion that what the lessee obtains from a lessor is in substance a service (e.g. in the case of a lease of real estate, the service provided by the lessor to the lessee is use of open space). A lease does not represent the sale of a good unless the lease falls into the definition of a "finance lease" defined under IAS 17.

**Other concerns and comments on consumption**

My other concerns and comments on the issue of consumption are as follows:

First, I do not agree with the use of looking at the degree of consumption to determine whether a lease is categorised as a Type A or Type B lease. I believe this represents a rule and is a compromise to address the strong objections to the original proposals that were submitted by companies that lease real estate. A conceptually sound and clear principle should be capable of being applied to all leases irrespective of the type of asset leased.

Second, the notion of consumption under the proposals is to be used by lessors in Type A leases to determine the percentage of the underlying asset to be de-recognised as this part of the leased asset will be regarded as having been effectively "sold" to the lessee. The "sold" portion will be replaced with a receivable. Although at first glance this looks like a reasonable approach, I believe it introduces a new accounting concept that will allow the partial de-recognition of assets even though the owner retains a one hundred percentage interest in the leased asset. In other words, although
the lessor still retains an interest in the asset and holds all the risks and rewards of ownership of the underlying asset, the lessor will be required to de-recognise part of the leased asset and replace it with a receivable. I believe this is inconsistent with the current requirements on when sales or de-recognition of assets are allowed.

Third, the proposals will mean that in the financial statements of a lessor there will be different accounting policies adopted for each component (e.g. the receivable or residual) of the same asset even though the leased asset is regarded as a single asset or unit of account by both the lessee and lessor.

Fourth, I would also like to point out a critical oddity and inconsistency. Paragraph 11 on page 14 of the ED states the following:

"A physically distinct portion of an asset (for example, a floor of a building) can be an identified asset. However, a capacity portion of an asset (for example, a capacity portion of a fibre-optic cable that is less than substantially all of the capacity of the cable) cannot be an identified asset because it is not physically distinct from the remaining capacity of the asset."

The above tries to identify what is an identified asset and states that a capacity portion of an asset (albeit less than substantially all the capacity of the asset) cannot be an identified asset. In my view, this seems to contradict the whole concept of a right-to-use model as the model requires looking at an asset as a bundle of rights to economic resources or service potential and capacity that is divisible and can be used by different parties. In my view a portion of capacity is equivalent to a portion of the economic resources embodied in the underlying asset and this effectively represents the right-to-use. Under the ED such rights will be required to be recognised as an identified asset.

**Implications of the concept of right-to-use on other contracts and commitments**

I believe the right-of-use concept introduced through this ED will have major implications on how one should account for other contracted commitments. Currently, accounting is primarily concerned with accounting for completed transactions and not contracts. However, if capitalisation of a rental contract is made where no legal equity exists, it would be logical to consider what other contracts and commitments should be capitalised. These would include:

- a contract to supply raw materials
- a contract to build or supply an airplane or a sea vessel
- a contract to supply assets such motor vehicles or carriages that will be used as fixed assets
- a contract to extend credit, such as bank overdraft facilities and loans
- a contract of employment, including both fixed term and variable term employment contracts
In my view an employment contract, particularly a fixed term contract, clearly is a lease of an economic resource. If the right-to-use concept is sound it should be applied universally and the ultimate question is how should one account for the above contracts.

A lease contract is time-based and is an executory contract

I was surprised that neither the ED nor the Basis for Conclusions included any discussion whatsoever on whether a lease contract is an executory contract.

An essential feature of all leases is that they all include a commencement date and an expiry date. Because of the time-based feature of all leases, the performance obligations of the lessor inherently must be performed over time. A lease contract requires re-examination at regular intervals for any proper analysis of whether there has been proper completion of performance obligations under the contract. Similar to other long term contracts, the lessor is required to carry out a series of performance obligations, that is, the lessor’s obligations cannot be determined as being fulfilled at a single point in time, but over points of time between the commencement and expiry date of the lease.

Unfortunately, in contrast to this, the ED takes the position that the lessor’s obligations are all fulfilled once he makes the asset available to the lessee at the commencement date of the lease. In my opinion, this cannot be true as the lessor has continuing obligations to make the underlying asset continuously available to the lessee in a fit and proper state for the full lease term. Making an asset available at the commencement date of the lease does not mean that the asset remains available to the lessee at a future date. The proper performance of the lessor’s obligations must be reassessed at regular future intervals and I believe these intervals would be normally when the rental payments are payable by the lessee.

Recognising an asset under the right-to-use model at the commencement of the lease means that the contract is deemed an "executed" contract. However, as a lease contract is time-based this logically cannot be possible. What is made available today would not necessarily be regarded as being made available in the future. Circumstances may change.

In my opinion, a lease contract is not an executed or completed transaction at the commencement date of the lease in the sense that the obligations of both have been completed to the satisfaction of both parties. It rather is a contract where there are mutual promises to perform or promises to make a series of future transactions as there are performance obligations to be carried out by both parties.

I believe a lease is an executory contract. The performance obligations to make available the leased asset in a fit and proper state remain performance obligations throughout the term of the lease and only cease on the expiry date of the lease. In my opinion, the existence of continuing or multiple performance obligations throughout the lease term is the relevant fact.

The performance obligation of the lessor can be best understood by looking at a few simple scenarios. A burst water pipe or flood, fire or any other event which was not caused by the lessee that results in the asset not being made available to the lessee means that the lessor’s performance
obligations have not been met. The amount of work, whether large or small, that may be required by the lessee to restore and make leased asset available to the lessee is irrelevant. It would also be clear that such events would rightly relieve the lessee of its performance obligations to pay lease rentals until the asset has been restored and made available to him.

Looked at from another perspective, a question that may be asked is this. **Does a lease represents the sale of goods or does it represent the provision of a service?** I believe normally a lease cannot be regarded as a sale of goods as by its very nature the risk and rewards of ownership of the leased asset is retained by the lessor. The exception is a "finance lease" as defined in IAS 17 which are in substance purchases of assets. Moreover, a sale of goods is normally made at a single point in time but a lease is time-based. By default a lease therefore must represent something more akin to the provision of a service.

It is worth mentioning here that under the proposals to revise IAS 18, the Revenue standard, there is a move to the notion of completion of "performance obligations” and attempts are being made to avoid distinguishing a "sale of goods" from "the provision of services”. However, even if the performance obligations approach is used, the answer is the same as a lease is a time-based contract. The performance obligations of a lessor do not cease at the single point in time when the asset is made available to the lessee at the commencement of the lease but continues throughout the lease term.

To support the IASB’s view that a lease is not an executory contract, in paragraph BC7(b) of the 2010 ED on leases, it was stated that:

"**a simple lease is not an executory contract after the date of commencement of the lease. When the lessor provides access to the underlying asset, the lessee has an unconditional right to use the underlying asset and therefore an unconditional liability to make lease payments. At that point the lessor cannot prevent the lessee from using the underlying asset nor can the lessee avoid payment without causing a breach of contract”**.

I believe the above actually supports the fact that a lease is an executory contract as it says "**When the lessor provides...** (with the key word underlined for emphasis)”. The right to use the asset and the liability to make lease payments only arises if the asset is in fact made available. In a time-based contract the assessment of whether the asset is made available must be assessed at regular intervals during the lease term.

In summary, I believe a lease contract is an executory contract. Both the lessor and lessee have future obligations to perform. A lessor’s obligation is to initially make, and then to continue to make, the leased item available to the lessee over the lease term. For the lessee, in addition to complying with other terms and conditions of the lease contract, the lessee’s obligation is to pay the rents when due but if, and only if, the leased item is made available to the lessee in the relevant period.
A lease does not create a liability for the lessee for the full amount of rental due for the whole lease term once the leased asset is delivered (or made available) to the lessee.

Paragraph BC15 and BC16 of the Basis for Conclusions states the following to support the IASB's position that a lease creates a liability for the full amount of rental payments due once the underlying asset has been delivered:

“BC15 The Conceptual Framework defines a liability as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.” Concepts Statement 6 states that “liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” The main characteristics of both definitions of a liability are that the entity has a present obligation that arises from a past event, and the obligation is expected to result in an outflow of economic benefits. The boards concluded that the lessee’s obligation to make lease payments meets the definition of a liability for the following reasons:

(a) the lessee has a present obligation to make lease payments once the underlying asset has been delivered (or made available) to the lessee. That obligation arises from a past event—the signing of the lease and the underlying asset being delivered (or made available) for use by the lessee. The lessee has no contractual right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term. In addition, unless the lessee breaches the contract, the lessor has no contractual right to take possession of, or prevent the lessee from using, the underlying asset until the end of the lease term.

(b) the obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments in accordance with the terms and conditions of the lease.

BC16 Consequently, the boards concluded that a lessee’s obligation to make lease payments meets the definition of a liability in the Conceptual Framework and in Concepts Statement 6.”

With due respect, I disagree with the analysis.

The most important part of the definition is that a liability is a “present obligation”.

I believe there are two tests. The first test is to determine whether there exists any obligations and to identify what they are. The second test is to determine which obligations are present obligations and which obligations are future obligations. This second test assists in identifying the timing for recognition of the liability and in quantifying the quantum of the liability.

I believe the first test can be made by asking the question:

What are the obligations of the lessee?

The answer to this question should be to comply with the terms and conditions of the lease agreement. To simplify the analysis, I would restrict the requirements to the basic requirement of paying the monthly rentals due at the end of each month during the lease term. The lessee therefore has multiple performance obligations (monthly rental payments) and whether each
obligation has been satisfied will be determined by looking at whether the monthly payments had been paid on the due dates.

Having determined the existence of obligations, the second test can be made by asking the following two questions. The second question has been added to address what is being proposed in the ED.

1. **At the reporting date**, what is owed (by the lessee) to the other party (the lessor)?

2. **At the reporting date**, has the lessee an obligation to pay the amount of rent payable for full period of the lease?

The reference to "At the reporting date" is needed to distinguish a "present" obligation from "future" obligations.

The answer to the first question of this second test would be the rental payments due for the expired period of the lease up to the reporting date. If payments have been made on time there is no amount owed to the lessor as all amounts due have been paid.

The answer to the second question must be a no. However, in measuring the liability the ED takes the position that all future amounts due under the lease are immediately due once the asset is delivered (or made available) to the lessee. I believe this cannot be right as the lessee does not have an obligation to pay all future rents once the asset is delivered to him. In my opinion such an amount being owed is also not expected by the lessor. If it was it would have been stated in the lease agreement.

In my view, a present obligation (a liability) is the amount owed at the reporting date and does not include the amounts due in the future. A possible analogy can be seen by looking at a bank overdraft facility where the borrower also has a right-to use, namely, a right to draw on the overdraft facility. What is normally recorded as a liability is not the total committed overdraft facility but only that which has been drawn as this is the amount that is owed to the bank. Similarly, a lease contract represents a commitment to pay rentals over several blocks of time during the lease term but only if the leased asset is made available in the relevant period. The present obligation of the lessee at a reporting date is what he owes at that date and not what he has committed to pay after that date. It is necessary to distinguish present obligations from future obligations. In the case of a lease, future rent payable is contingent on the leased item being made available to the lessee.

I understand that the courts have held that the relationship of a lessor with a lessee is not the same as between a debtor and creditor. A lessee who is not in default of any lease covenants to pay rent creates no debt until the rent becomes due. The specific debt is only incurred in each rental or contract period as the service is rendered or executed by the lessor.

**Conclusion**

Because of the above concerns which I believe are significant, I strongly believe that the Board should at this time defer any significant work on the Exposure Draft. The Exposure Draft raises wider and more fundamental conceptual issues of what is the meaning and the key attributes of an asset and a liability and when they should be recognised and de-recognised. As mentioned in the
beginning of my letter it would be prudent to wait the outcome of the results of the Conceptual Framework review before any further work is done on this exposure draft on leases.

I hope the above comments are useful. If you require any further elaboration on the matters raised, please let me know.

Yours faithfully,

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