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Dear Sir or Madam,

Comments on the Exposure Draft *Leases*

We appreciate the many years of efforts in the Leases project by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) ("the boards") and their decision to expose the revised proposals for the financial reporting of leases, an important transaction for many entities. Re-exposing the Exposure Draft, *Leases*, (the "revised ED") will provide a wide range of interested parties with another opportunity to comment on the revisions the boards have made to the Exposure Draft, *Leases* issued in August 2010 (the "2010 ED").

Overall comments

1. We support the objective of the boards' Leases project to improve the financial information about lease transactions. However, we do not support the boards finalizing the standard as proposed for the following reasons:
   (a) Lessee accounting: We are concerned from a cost-benefit perspective that the right-of-use model would be applied (and thus assets and liabilities would be recognised) for all leases except for short-term leases. Accordingly, additional consideration from a cost-benefit perspective is necessary in the forthcoming redeliberations (Please refer to paragraphs 19 and 21of this comment letter).

   (b) Lessor accounting: The extent of the risks and rewards associated with the residual asset retained by the lessor should be considered for the classification of leases by the lessor (Please refer to paragraphs 28 to 35 of this comment letter).

(c) Identification of leases: For contracts that contain both a lease component and a service component, if there are no observable prices for any of the components in the contract (paragraphs 23(b) and (c) of the IASB's revised ED), it is inappropriate for the lessee to always account for such contracts as contracts with a single lease component (Please refer to paragraphs 8 and 9 of this comment letter).

2. In addition to considering the proposals in the revised ED within the ASBJ, we solicited and received public comments from constituents in Japan on the revised ED, taking into account the significance of leases in financial reporting. The purpose of this procedure was to better understand the impacts of the proposals in the revised ED on Japanese accounting practices and to identify beforehand the aspects of the proposal in which we need to ask for improvements from the Japanese point of view. Accordingly, this comment letter includes the views of a wide range of constituents in Japan. Direct quotations of views from constituents in Japan are shown in *italics* in this comment letter.

3. Many preparers of financial statements who have commented on the aforementioned invitation to comment are opposed to the proposal in the revised ED, arguing that the benefits arising from recognising assets and liabilities based on the revised ED for what are currently classified as operating leases in Japan would not outweigh the costs.[1] In addition, for the purpose of relieving such costs, these preparers are asking to consider the following treatments in the Leases project (Please refer to 'Comments from constituents in Japan' following paragraph 25 of this comment letter).

(a) Providing more specific quantitative criteria for materiality than as defined in IFRSs (IAS 1 and IAS 8).

(b) Providing specific quantitative criteria for criteria related to extent (for example, "insignificant" in paragraph 29 of the IASB's revised ED).

Responses to the specific questions in the revised ED

Our responses to the specific questions in the revised ED are provided below.

Scope

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:

[1] According to the research recently conducted by the Japan Leasing Association, for listed companies in the first section of the Tokyo Stock Exchange (approximately 1,700 entities), the total of remaining lease payments arising from operating leases disclosed in footnotes is approximately 170 billion U.S. dollars (17 trillion Japanese yen). This amount accounts for approximately 1 % of the total assets of these companies.

(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.

(1). Definition of a lease and the determination of whether a contract contains a lease

4. We agree, except for the following paragraphs, with the definition of a lease and the notion that the determination of whether a contract contains a lease should be made based on whether the lessee controls the use of the identified asset.

5. Regarding paragraphs 18 and 19 of the IASB's revised ED, paragraph BC105(f) of the IASB's revised ED states that the customer is unable to derive benefits from the use of the asset when the asset has no value or use to the customer without the other deliverables in the contract. We think that this description, which is consistent with the proposal in the Revenue Recognition project, should be incorporated in the main text of the final standard. This would be useful for constituents to better understand the requirements.

6. Paragraph 19 of the IASB' s revised ED describes cases where the customer is unable to derive benefits from the use of the asset. However, we think that there could be other cases where the customer is unable to derive benefits from the use of the asset even when the conditions in paragraph 19 of the IASB's revised ED are not met. Accordingly, we are of the view that it is necessary to explain that the cases where the customer is unable to derive benefits from the use of the asset include, but are not limited to, those described in paragraph 19 of the IASB's revised ED.

(2). Separating components of a contract

(Lessor)

7. Under the proposed lease model in the revised ED, there would be more cases where the methods of recognising revenue would be different between lease components and service components compared to existing standards and, accordingly, the need to allocate consideration to these components would be

higher. We agree with the direction in the proposal to allocate to these components consistently with the requirement in IFRS X "*Revenue from Contracts with Customer*" as referred to in paragraph 22 of the IASB's revised ED.

(Lessee)

8. We disagree with the proposals in paragraphs 23(b)(ii) and 23(c) of the IASB's revised ED that, if there are no observable stand-alone prices for any of the components in a contract which contains a lease, the lessee shall combine the components and account for them as a single lease component, for the following reasons:

   (1) In practice, there are cases where it would be difficult for the customer (lessee) to obtain observable stand-alone prices for lease components and service components within a contract. The requirement in paragraphs 23(b)(ii) and 23(c) of the IASB's revised ED may be justified for cost-benefit reasons when service components are relatively small compared to the lease components.

   (2) Otherwise, we are concerned that service components that do not meet the definitions of assets and liabilities would be recognised by the lessee as right-of-use assets and lease liabilities. In these cases, we think that it is necessary to consider which component (that is, the lease component or the service component) is primary within the contract.

9. Based on the above discussions, we are of the view that, in the cases mentioned in paragraph 23(b)(ii) or 23(c) of the IASB's revised ED, the lessee should account for the components as a single lease component or a single service component based on whether the primary component in the contract is a lease component or a service component, rather than accounting for them as a single lease component in all cases. The primary component would be the component which represents the predominant rights the customer (lessee) obtains from the contract, normally the component which accounts for the majority of the total consideration in the contract. We think that it is practicable to objectively identify the primary component, even if there are no observable stand-alone prices for any component within a contract.

Comments from constituents in Japan

- *We received comments from users of financial statements regarding the judgement used to determine whether a contract contains a lease. These users argue that the requirements in paragraphs 7 to 19 of the IASB's revised ED and the illustrative examples provided thereto would be insufficient in practice, because there are no references to transactions in specific industries. In some cases these industry-specific* *transactions make it difficult in practice for entities to determine whether a contract contains a lease.*

- *We received the following concerns from preparers of financial statements.*

  (a) *Paragraph 19 of the IASB's revised ED, which describes the ability to derive benefits from use of an asset, lacks the economic perspective required to appropriately reflect the economic substance of the transaction. For example, in paragraph 19(a) of the ED, even if an additional service that is necessary to obtain the benefits from use of an underlying asset is provided separately from a different supplier, there could be a technical or economic barrier to receive that service separately from the other supplier.*

  (b) *There is a concern that two separate transactions, which are indifferent in substance from the customer's perspective, could be classified differently (that is, as a service or as a lease) under the proposal. This would impair comparability. For example, in a case where the supplier (lessor) has the substantive right to substitute the underlying asset and a case where the supplier does not have such substantive right, these two cases are indifferent because in both cases the lessee has the ability to use the underlying asset for a period of time.*

  (c) *Under the proposal, if there are no observable prices for any of the components in a contract which contains a lease, the lessee would combine the components and account for them as a single lease component. If service components are not insignificant compared to lease components, it would be inappropriate for the lessee to recognise a right-of-use asset and a lease liability for the service components. In such a case, the lessee should account for the components as a single lease component or a service component considering whether the primary component is a lease or service rather than always accounting for them as a single lease component.*

- *We received the following comments from auditors.*

  (a) *The requirements in paragraphs 7 to 19 of the IASB's revised ED and the illustrative examples provided thereto regarding the judgement used to determine whether a contract contains a lease are unclear and insufficient to assure consistent application to a variety of lease transactions. For example, Examples 2 and 4 in the illustrative examples are insufficient to apply requirements in paragraphs 11 and 19(b) consistently. These requirements and* *examples need to be improved.*

(b) *The requirements in paragraphs 20 to 24 of the IASB's revised ED and illustrative examples provided thereto may result in inconsistent application when entities apply these requirements and examples to separate lease components and non-lease components. For example, example 1 and example 3 in the illustrative examples are insufficient to apply requirements in paragraphs 20 to 24 consistently. Additional examples or improvemens to existing examples are needed to ensure objective judgement.*

The accounting model

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?

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?

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?

10. Our comments to Questions 2 to 4 of the revised ED are structured as follows:

    (a) Symmetry between lessee accounting and lessor accounting

(b) Lessee accounting (responses to Question 2)

(c) Lessor accounting (responses to Question 3)

(d) Lease classification (responses to Question 4)

(a) Symmetry between lessee accounting and lessor accounting

11. Our understanding is that many constituents have asked for symmetrical treatment between lessee accounting and lessor accounting.

12. However, we think that, conceptually, lessee accounting and lessor accounting do not necessarily need to be symmetrical for the following reasons:

    (1) The classification of leases is a matter of cost allocation for the lessee, whereas the classification of leases is a matter of revenue recognition for the lessor. Cost allocation and revenue recognition have different objectives and, therefore, they do not necessarily need to be symmetrical.

    (2) As described later in paragraph 29 of this comment letter, economic positions of the lessee and the lessor are different in that the lessor's involvement extends to the residual asset as well as the right-of-use asset transferred, whereas the lessee's involvement is limited to the right-of-use asset.

13. In the following paragraphs, we will discuss lessee accounting and lessor accounting separately based on the assumption that symmetrical treatment for lessees and lessors is unnecessary.

(b) Lessee accounting

(On-balance treatment of leases)

14. As mentioned earlier in paragraph 9 of our comment letter, we think that, if there is no observable price for any component within the contract and the lease components are not the primary components of the contract, the lessee should account for the contract entirely as a single service component. The following paragraphs discuss whether a lessee should recognise associated assets and liabilities for all leases, excluding these types of contracts.

15. Paragraph BC21 of the IASB's revised ED states:

    > When the lessor delivers (or makes available) the underlying asset for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee now controls that right of use. Consequently, the lessee has an unconditional obligation to pay for that right of use.

16. On this point, paragraph 4.46 of the IASB's Conceptual Framework states:

> In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

17. The revised ED focuses on the rights to control the use of the underlying asset (that is, a portion of the rights inherent in the underlying asset) by using the right-of-use model, whereas IAS 17 focuses on the control of the underlying asset as a whole.

18. Our understanding is that, under this right-of-use model, a lease contract is no longer an executory contract at the commencement date, when the right to control the use of the underlying asset is transferred. This would result in recognising the associated asset (a right-of-use asset) and liability (a lease liability).

19. This right-of-use model has the potential to resolve some of the problems with IAS 17. However, we have the following concerns about the proposal and think that whether the right-of-use model should be applied to all leases except for short-term leases should be considered further.
    (a) In general, service components are more or less added to a contract which contains a lease. In some cases, it would be operationally difficult to discern lease components from service components (Please refer to the "comments from constituents in Japan" which follows paragraph 9 of this comment letter). Therefore, if the right-to-use model were to be applied to all leases, there may be cases where an asset and a liability would be recognised for such service components (Please refer to paragraph 8 of this comment letter).

    (b) There are a variety of leases that qualify as operating leases in accordance with IAS 17, including transactions similar to purchases of the underlying asset and transactions with a relatively short term. The proposed right-of-use model would require the lessee to capture the transfer of control to use the asset, even if the lease term is relatively short. Our understanding is that, for a portion of such leases, the exceptional treatment for "short-term leases" is provided in the revised ED based on cost-benefit considerations. However, for leases whose lease term is relatively short compared to the economic useful life of the underlying asset, we think that it is unclear whether the benefits to users would outweigh the costs resulting from applying the right-of-use model.

20. In addition, for typical service contracts with a non-cancellable period, it can be said that the customer would have a resource whose future economic benefits are expected to flow to the entity at the commencement of the service. Our understanding is that the IASB will discuss whether an asset and a liability should be recognised for such service contracts in its ongoing Conceptual Framework project.

21. Based on the above discussions, we think that, at least in the forthcoming redeliberations in the Leases project, additional consideration is necessary about the scope of transactions to which the right-of-use model is applied for the purpose of responding to the concerns mentioned in paragraph 19 of our comment letter.

(Classifying leases into two types)

22. For lessees, we agree with prescribing two types of leases with different expense recognition patterns. As pointed out by many constituents, economic substances of leases vary widely, and we support the notion that such economic substance should be reflected in the accounting for lessees.

(Classification of leases)

23. We are of the view that the classification of leases proposed in the revised ED could be justified because this proposal considers the relationship between the expected decline in the value of the underlying asset over the lease term and the lease payments compensating for such decline in the value.

(Subsequent measurement of the right-of use asset for Type B leases)

24. Paragraph BC185 of the IASB's revised ED states that, for the subsequent measurement of right-of-use assets for Type B leases, the proposed approach is the result of responding to concerns raised about the effects of the proposals in the 2010 ED on the lessee's profit or loss. However, the resulting depreciation of the right-of-use asset would be back-loaded over the lease term, which would result in inconsistent treatment with that for tangible assets (paragraph 62 of IAS 16) or that treatment for intangible assets (paragraph 97 of IAS 38).

25. Under Type B leases, the lessee would determine the amortisation of right-of-use assets in each period as the difference between the periodic lease cost, which is recognised on a straight-line basis, and the periodic unwinding of the discount on the lease liability. We think that, it would be necessary to further discuss and explain the following regarding the subsequent measurement of right-of-use assets:

    (a) How the proposed subsequent measurement can be justified compared to the treatment of general tangible and intangible assets.

    (b) Whether IAS36 should be applied for impairment of right-of-use assets similar to Type A leases.

Comments from constituents in Japan

- *From many users of financial statements, we received opinions strongly supporting the on-balance sheet treatment for lessees based on the right-of-use model for most if not all leases. They support the proposal because they will not need to adjust operating leases* *to compute, among other things, ROA and comparability will be improved dramatically between entities that use leases and entities that do not.*

- *We received the following strong objections regarding the proposed lessee accounting from many preparers of financial statements (please refer to the Appendix of this comment letter for details).*

  (a) One of the objectives of the Leases project is to reduce the opportunities to structure transactions in order to achieve off-balance sheet treatment. However, costs incurred by preparers in connection with on-balance sheet treatment for all equipment leases, which are currently not recognised, clearly outweigh the benefits to users of financial statements.

  (b) As to the requirement for lessees to recognise assets and liabilities for all leases, it is doubtful that sufficient cost-benefit analysis has been undertaken in the Leases project.

  (c) The following additional treatments would be needed to relieve implementation costs, because the lease standard will affect a broad range of entities.

  (1) *More specific quantitative criteria for materiality than as defined in IFRS (IAS 1 and IAS 8) should be provided.*

  (2) *A specific quantitative criteria for criteria related to extent (for example, "insignificant" in paragraph 29 of the IASB's revised ED and "major" and "substantially all" in paragraph 30 of IASB's the revised ED) should be provided.*

  (d) There are a variety of non-property leases, including transactions similar to purchases of underlying assets and transactions similar to receiving a service. As such, the proposal, which would classify most of these leases into Type A leases, does not reflect the variety of leases.

  (e) Most property leases cannot be viewed as an alternative to purchase the underlying assets. Accordingly, most property leases, except for leases that are currently classified as financial leases under IAS 17, should be scoped out of the revised ED.

  (f) Amortization of right-of-use assets under Type B leases is back-loaded over the lease term, but there is no reasonable explanation provided in the revised ED as to why the amortization method for Type B leases is different from the

depreciation/amortization methods for other non-financial assets.

(g) The requirements for impairment in IAS 36 should not be applied to right-of-use assets of Type B property leases.

(h) For lease transactions in which an entity should recognise an asset and a liability under the proposal, finance leases under IAS 17 should be classified as Type A leases and an operating leases under IAS 17 should be classified as Type B leases.

(i) Regarding leases of non-core assets of an entity's business, an entity should recognise lease payments in the profit and loss on a straight-line basis over the lease term rather than applying the proposed requirements.

(c) Lessor accounting

(Classifying leases into two types)

26. For lessors, we agree with prescribing two types of leases with different revenue recognition patterns.

27. As pointed out by many constituents, the economic substance of lease transactions vary widely ranging from those similar to sales of the underlying assets to those similar to providing services. We think that differentiating the pattern of revenue recognition (that is, one-time recognition or over-time recognition) based on such economic substance would result in faithful representation of the economics of these transactions.

(Classification of leases)

28. We disagree with the proposal that the two types of leases for lessors should be differentiated based on the extent of the consumption of the underlying asset by the lessee. This is because the proposal does not consider the risks and rewards associated with the residual asset retained by the lessor.

29. The lessor continues to retain the residual asset after the right-of-use asset is transferred to the lessee. Accordingly, the economic position of the lessor is different from that of the lessee because the risks and rewards for the lessee under the lease is limited to those associated with the right-of use asset.

30. The lessor is exposed to the volatility of future cash flows arising from the residual asset (that is, the volatility in price) even after the right-of-use asset is transferred to the lessee. Such future cash flows arsing from the residual assets are normally collected by the lessor through re-leasing the asset, using the asset or selling the asset. We are of the view that, for classifying leases by the lessor, such volatility in the residual asset should be considered.

31. In the Revenue Recognition project, it was proposed that the notion of a transfer of the risks and rewards of ownership of the asset be included as an indicator for determining the satisfaction of

performance obligations. Accordingly, we think that a similar notion should be incorporated for determining whether the lessor should initially recognise revenue (or how the lessor should classify the two types of leases) for its lease transactions.

32. Based on the above discussion, we are concerned that the lessor recognises one-time revenue at the commencement date even when the lessor is exposed to a certain level of volatility in the residual asset. This is because, in such cases, revenue recognised at the commencement date is likely to be reversed subsequently as a result of possible future losses when the underlying asset is returned.

(Our proposed Alternative A)

33. We are of the view that the two different types of leases for lessors should be distinguished based on the extent of the volatility of the value of the residual asset retained by the lessor. On this point, when either of the following indicators is met, the lease should be classified to Type A under the proposal in the revised ED.

    (a) Leases for which the lessor has transferred substantially all risks and rewards associated with the underlying asset to the lessee. For such leases, the volatility in the value of the residual asset is relatively small because the lessor should have collected most of the value of the underlying asset as consideration for the right-of-use asset transferred to the lessee.

    (b) Leases for which the historical trends in the prices for the used assets in a liquid external market indicate that it is evident that the volatility of the value of the residual asset at the end of lease would be relatively small. For such leases, even when the residual asset is not so small compared to the underlying asset, the volatility of the value of the residual asset would be limited to a certain extent because of the existence of the historical trend data.

(Our proposed Alternative B)

34. However, we note that, in terms of indicator (b) in our proposed Alternative A in the previous paragraph, in many cases it would be operationally challenging for the entity to demonstrate that the volatility of the value of the residual asset is small using sufficient data. In addition, we think that the population of leases for which indicator (b) is met would be relatively small when compared with the population of leases for which indicator (a) is met.

35. Accordingly, our proposed Alternative B would focus only on indicator (a) in paragraph 33 of this comment letter from the viewpoint of operationalizing the notion underlying Alternative A. Under Alternative B, leases for which the lessor transfers substantially all risks and rewards associated with the underlying asset to the lessee is classified as Type A leases. In this regard, the distiction between the two types of leases for lessors under Alternative B would be somewhat similar to the distinction between finance leases and operating leases under IAS 17.

<u>Comments from constituents in Japan</u>

- *We received the following opposing opinions from many preparers of financial statements regarding the proposed lessor accounting.*

  (a) *The risks and rewards associated with the underlying assets retained by lessors are ignored in the proposed lessor accounting. Accordingly, the proposal does not reflect the economic substance of the lessor's lease transactions and thus does not improve IAS 17.*

  (b) *It is difficult in practice for the lessor to always measure the fair value of the underlying asset (paragraphs 73 to 75 of the IASB's revised ED).*

  (c) *In cases where the fair value of the underlying asset is greater than its carrying amount, recognising profit at lease commencement date in all cases (paragraphs 73 and 74 of the IASB's revised ED) is not reasonable. This is because the likelihood of incurring a loss when the underlying asset is returned would increase if profit is recognised at the lease commencement date.*

  (d) *IAS 17 is considered to have worked well for lessors and, therefore, the lessor accounting treatment in IAS 17 should be retained.*

(d) Lease classification

36. As mentioned in paragraphs 28 to 35 of this comment letter, we disagree with the proposed notion that the two types of leases for lessors should be distinguished based on the extent of consumption of the underlying asset by the lessee. However, the following comments are related to property and non-property leases based on the two types of leases proposed in the revised ED.

37. Property is economically different from other assets in that it contains a land element for which the lessor does not normally consume over the lease period. Accordingly, we agree with the direction of the proposal that, by focusing on the economic substances of property, different requirements are provided for leases of property and leases of other (non-property) assets.

38. However, we are concerned with applying the proposed requirements to property leases with both land and building components, when most of the value comes from either the land element or the building element. Addressing this concern may be justified from the viewpoint of providing information that better represents the extent of consumption of the underlying asset.

(Property leases where most of the value comes from the building element)

39. When most of the value comes from the building element, the portion of the building consumed by the lessee over the lease term may be critical for determining the extent of the consumption of the entire property. Classifying most of these types of leases as Type B leases would result in a different outcome from applying the general principle for classifying leases in the revised ED (that is, the extent of consumption of the underlying asset).

(Property leases where most of the value comes from the land element)

40. When most of the value comes from the land element and the lease term is for the most of the remaining economic life of the building (paragraphs 30(a) and 33 of the IASB's revised ED), the portion of the building consumed by the lessee over the lease term may be not critical when considering the extent of consumption of the entire property (that is, the land and building combined). Classifying all of these types of leases as Type A leases merely because the criterion described in paragraph 30(a) of the IASB's revised ED is met, would result in a different outcome from applying the general principle for classifying leases in the revised ED (that is, the extent of consumption of the underlying asset).

Comments from constituents in Japan

- *The views of preparers of financial statements were split regarding the proposal regarding the classification of leases.*

  (a) *Some preparers are opposed to the proposed classification of leases based on the nature of the underlying assets (that is, property or non-property), because it would not reflect the economic substance of leases and the lessors' business model and thus would not achieve faithful representation.*

  (b) *Other preparers agree with the proposed classification of leases based on the nature of the underlying assets. However, they expressed the following views regarding property leases.*

  (1) The term "remaining economic life" in paragraph 30 of the IASB's revised ED should be modified to "total economic life", because the requirement proposed in paragraph 30 of the IASB's revised ED may result in different classifications for leases for the same building, which have the same lease term. For example, when the building is new it is likely to be classified as a Type B lease and when the building is old it is likely to be classified as a Type A lease. It is inappropriate for leases of the same building to be classified differently merely because of the difference in the commencement dates.

(2) *When an entity sub-leases property, there could be cases where the lease payments paid to the master-lease's lessor are determined based on lease payments received from the sub-lease's lessee. In such cases, it would be inappropriate to classify leases based on the economic life of the property itself. Accordingly, for the classification of property leases, consideration of other characteristics (for example, the. existence of variable lease payments) should be added as criteria, which is similar to paragraph 12 of IAS 17.*

(3) *Under the proposal, a property lease is classified as a Type A lease if the either paragraph 30(a) or paragraph 30(b) of the IASB's revised ED is met. If a property comprises a used building and land and the remaining economic life of the building is relatively short, such lease is likely to meet paragraph 30(a) of the IASB's revised ED but the present value of the lease payments may be considerably smaller than the fair value of the whole property. It is inappropriate that such property lease be classified as a Type A lease merely because paragraph 30(a) of the IASB's revised ED is met because it would be inconsistent with the notion proposed in the revised ED that property, including land, should generally be classified as Type B leases based on its nature. Accordingly, the criteria for classifying property leases as Type A leases should require that both paragraph 30(a) and paragraph 30(b) need to be met.*

Measurement

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?

41. We note that paragraph BC140 of the IASB's revised ED states that applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably assured' or 'reasonably certain' in existing US GAAP and IFRS. We are of the view that the main text of the final standard should clarify that the proposed threshold is as high as 'reasonably assured' or 'reasonably certain' in existing standards and describe that all factors mentioned in paragraph B5 of the IASB's

revised ED (that is, contract-based, asset-based, market-based and entity-based factors) should be used as indicators for objectively determining whether the threshold is met.

42. An option to extend the lease gives rise to a right for the lessee. Until the lessee exercises the option, the lessee does not have a present right to use the underlying asset nor a present obligation to make lease payments for the optional period.

43. One possible method for the lessee to faithfully represent the economics of this option may be to recognise an asset for the option as a separate component of the lease. However, this method would be operationally challenging, at least as of today, in particular in terms of measurement. This is because an option to extend the lease differs from general financial options in that an option to extend the lease may contain the characteristics of a real option.

44. On the other hand, we are concerned about not recognising any options to extend the lease because it would not reflect the difference between leases with and without options. Accordingly, we agree with the notion in the proposal that lease payments related to certain options to extend the lease term should be accounted for as lease liabilities of the lessee and lease receivables of the lessor.

45. This accounting would lead to recognising lease payments related to the option to extend the lease term as a liability even though the obligation to pay such lease payments would not be a present obligation until the option is exercised. Accordingly, the option to extend the lease should be recognised as a lease liability or a lease receivable only when the probability to exercise the option is sufficiently high.

46. It is not necessarily clear from the main text of the revised ED as to how high the proposed threshold would be using the notion of "significant economic incentive" in the proposal. However, if the intention of the proposal is, as described in paragraph BC140 of the IASB's revised ED, to provide a similar threshold as high as that required in existing US GAAP and IFRS, we would agree with the direction of the proposal on the condition that the main text of the final standard clarifies this point.

<u>Comments from constituents in Japan</u>

- *We received from many preparers of financial statements the following views with regard to "significant economic incentive."*
  - *Paragraph BC140 of the IASB's revised ED states that "significant economic incentive" would provide a threshold that is similar to "reasonably certain" in IAS 17. Therefore, the wording "reasonably certain" as described in IAS 17 should be maintained instead of providing "significant economic incentive" to clarify that an option period is included in the lease term only when the likelihood of the option*

being exercised is high.

- *Some preparers of financial statements are concerned that an entity would need to reassess significant economic incentive to exercise an option at a time close to the end of the option period, remeasure right-of-use assets and lease liabilities and recognise profits or losses (paragraphs 43 and 78 of the IASB's revised ED). These preparers think that the remeasurement and the recognition of profits/losses cause undue costs to preparers and would not provide useful information to users.*

- *Other preparers of financial statements are concerned about paragraph B5(d) of the IASB's revised ED which states that "the importance of that underlying asset to the lessee's operations, considering, for example ... the location of the underlying asset." These preparers argue that, when a lessee is engaged in a retail business using a leased property, it is inappropriate to determine the lease term by focusing only on one factor such as the underlying asset's location. These preparers are of the view that this should be further clarified so that an entity needs to consider all factors in paragraph B5 of the IASB's revised ED comprehensively.*

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?

47. Our understanding is that the IASB's existing Conceptual Framework does not address whether it meets the definition of a liability (in terms of whether a present obligation exists) if variable lease payments depend on the entity's future actions (for example, variable lease payments which are linked to lessee's future performance or use of an asset).

48. However, recognising this type of variable lease payments as lease liabilities for lessees and lease receivables for lessors may provide information that is relevant to users of financial statements.

49. We note that many respondents to the 2010 ED commented that it would be challenging to reliably estimate variable lease payments which are linked to the lessee' performance or usage.

50. From the above discussions, at this point, we propose that, in addition to variable lease payments that depend on an index or a rate, variable lease payments that depend on the entity's future actions should

be included in lessee's liabilities and lessor's assets when these variable lease payments can be reliably estimated.

51. The IASB's ongoing Conceptual Framework project is currently discussing whether a present obligation exists if the eventual need to transfer economic resources depends on the entity's future actions. We note that, for variable lease payments, revisions may be necessary in the future, as a result of responding to the IASB's conclusion in the Conceptual Framework project.

52. Further, paragraph BC153 of the IASB's revised ED states that in-substance fixed lease payments are unavoidable and, thus, economically are indistinguishable from fixed lease payments. However, such in-substance lease payments are not defined or explained in the main text of the revised ED. Accordingly, this point should be clarified in the main text of the final standard.

Transition

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?

53. Lease transaction may have long durations and the lessee or lessor may not have the information to apply full retrospective approach at the transition date. Accordingly, we agree with, from the viewpoint of relieving concerns about implementation costs, providing a choice of using the modified retrospective approach.

54. For first-time adopters which have applied the lease standard equivalent to IAS 17 as their previous GAAP, applying the proposed transition requirements in the revised ED may be justified from a cost-benefit perspective (for example, paragraphs C10 to C12 of the IASB's revised ED for leases previously classified as finance leases). On this point, we think that further consideration in the forthcoming redeliberations is necessary.

Comments from constituents in Japan

- *We received the following views from preparers of financial statements.*

(a) Many preparers are opposed with the transition proposals. The revised ED proposes major changes to the treatment of operating leases from IAS 17. Accordingly, more practical expedients, such as non-application to lease contracts whose date of inception was before the effective date of the new lease standard or the prospective transition approach where the new lease standard will apply only to lease contracts whose date of inception is after the effective date of the new lease standard, should be provided.

(b) Regarding the effective date, preparers believe that a sufficient period (at least three years) for preparation should be provided from a practical standpoint so that it would alleviate any excessive burden on preparers.

Disclosure

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?

55. We generally support the proposed disclosure requirements in the revised ED. However, we have the following comments.

56. Paragraph 61 of the IASB's revised ED states that the lessee should disclose a reconciliation of opening and closing balances of right-of-use assets by class of underlying asset separately for Type A leases, Type B leases and right-of-use assets measured at revalued amounts. Paragraphs 103 and 104 of the IASB's revised ED state that, for lease receivables and residual assets, the lessor should disclose a reconciliation of the opening and closing balances. However, the FASB's revised ED does not have a similar requirement for a reconciliation of balances of right-of-use assets because, in the FASB's view, the benefits of the information would not justify the costs of providing it (paragraph BC206 of the IASB's revised ED).

57. For this requirement to disclose these reconciliations, users in Japan generally support the proposal but preparers in Japan have expressed concerns about whether sufficient cost-benefit analysis for disclosing such information has been conducted. We are of the view that further consideration and explanation to constituents is necessary regarding whether the benefits of providing such disclosure would justify

the associated costs.

<u>Comments from constituents in Japan</u>

- *We received the following views from users of financial statements.*

  (a) Disclosure requirements in the revised ED are highly appreciated because they would provide useful information. In particular, the following items are useful from the views described.

  (1) The lessee's maturity analyses of lease liabilities are useful to understand liquidity risks.

  (2) The lessor's maturity analyses of the lease receivables are useful to forecast future cash flows.

  (3) The lessee's reconciliation of opening and closing balances of the right-of-use assets and the lease liabilities would provide information about the factors that increased and decreased the balances and users can evaluate the certainty and validity of the amounts provided in the statement of financial position.

  (b) On the other hand, the disclosure requirements in the revised ED may include requirements which cause significant costs and difficulties to preparers in practice. Therefore, some immaterial disclosure could be omitted from a materiality perspective.

- *We received from many preparers of financial statements the following objections to the disclosure requirements in the revised ED.*

  (a) One of the objectives of the Leases project is to require lessees to recognise assets and liabilities on their statements of financial position. Therefore, as a result of this, the volume of disclosure requirements should be reduced. Disclosure requirements in the revised ED should be reconsidered from a cost-benefit perspective.

  (b) For example, the following disclosure requirements should be deleted or modified.

  (1) With regard to the lessee's information about the nature of its leases (paragraph 60(a) of the IASB's revised ED) and the lessor's information about the nature of its leases (paragraph 100(a) of the IASB's revised ED), it is very

challenging for preparers who have a large number of lease contracts to collect this information for disclosures while there are doubts about substantial benefits to users.

(2) With regard to lessee's maturity analysis of the lease liabilities (paragraph 67 of the IASB's revised ED), it should be similar to the disclosure requirements for other financial liabilities. Furthermore, with regard to the lessor's maturity analysis of lease receivables (paragraph 106 of the IASB's revised ED), it should be similar to the disclosure requirements for other receivables.

(3) The following proposed disclosures would cause significant costs to preparers but limited benefits to users of financial statements.

- ✓ *The lessee's reconciliation of the right-of-use assets (paragraph 61 of the IASB's revised ED)*
- ✓ *The lessee's reconciliation of the lease liabilities (paragraph 64 of the IASB's revised ED)*
- ✓ *The lessor's reconciliation of the lease receivables (paragraph 103 of the IASB's revised ED)*
- ✓ *The lessor's reconciliation of the residual assets (paragraph 104 of the IASB's revised ED)*

IAS 40 *Investment Property*

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?

Comments from constituents in Japan

- *We received an objection to the proposal regarding the consequential amendment to IAS 40 from preparers of financial statements. They are opposed to the proposal because they are concerned that calculating the fair values of the right-of-use assets of Type B leases is operationally difficult and the methodology of the calculation is far from well-established in practice. Accordingly, in their view, calculating and disclosing the fair values incur significant costs and allow arbitrary judgements and thus the costs outweigh the benefits of users.*

Other comments (Short-term leases)

58. Paragraph BC298 of the revised ED states that the boards rejected the approach to defining short-tem leases consistently with the definition of the lease term because of concerns that leases could be structured to obtain short-term lease accounting. However, we think that the proposal focuses too much on the viewpoint of avoiding structuring opportunities. Furthermore, including any optional periods for defining short-term leases, as proposed in the revised ED, may not result in the simplification of the proposal. This is because in practice it is considered to be rare for a lease contract not to contain any option to extend the lease term.

59. We think that considering the probability of exercising the option to extend the lease would better reflect the economics of leases. There may be more than one way to reflect this probability but treating the definition of short-term leases similarly to that of the lease term would result in avoiding complexity.

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We hope our comments will contribute to the forthcoming deliberations of the Leases project.

Yours sincerely,

Atsushi Kogasaka
Chairman of the Lease Accounting Technical Committee
Vice Chairman of the Accounting Standard Board of Japan

(Appendix) Major comments from preparers of financial statements in Japan regarding lessee accounting

The following paragraphs summarize the major comments from preparers of financial statements in Japan regarding lessee accounting. We attach these comments in our comment letter because we think informing you of the Japanese preparers' concerns in detail would be useful for the boards' future discussions. Some of the comments are provided on the assumption that the right-of-use model is applied, even though preparers may not agree with applying the right-of-use model in the first place.

(a) *On-balance sheet treatment for insignificant amounts of equipment leases, which are currently not recognised as operating leases, is hardly meaningful, while the proposed lessee accounting would cause significant practical burdens and costs to preparers of financial statements. Such costs clearly outweigh the benefits to users of financial statements.*

(b) *As to the requirement for lessees to recognise assets and liabilities for all leases, it is doubtful that sufficient cost-benefit analysis has been conducted in the Leases project.*

(c) *The following additional treatments are needed to relieve implementation costs because the lease standard would affect a broad range of entities.*

(1) *A more specific quantitative materiality criteria than as defined in IFRSs (IAS 1 and IAS 8) should be provided.*

(2) *Specific quantitative criteria should be provided for criteria related to extent (for example, "insignificant" in paragraph 29 of the IASB's revised ED and "major" and "substantially all" in paragraph 30 of the IASB's revised ED).*

(d) *Under the proposal regarding classification of leases, most non-property leases would be classified as Type A leases. As a result, in addition to on-balance treatment, front-loaded expenses would be recognised in the statement of profit or loss and other comprehensive income. However, there are a variety of non-property leases, which include transactions similar to purchases of the underlying assets and transactions similar to receiving services. As such, the proposal, which would classify most leases as Type A leases, does not reflect this variety of leases.*

(e) *The proposal for lessee accounting requires on-balance treatment for all leases except for short-term leases. Such leases include (a) lease transactions, which are clear not an "alternative way to purchase the assets" and (b) lease transactions, which can be cancelled anytime by the lessee (but the lessee does not have a significant economic incentive to cancel the option). Recognising right-of-use assets for these types of lease transactions does not reflect the economic substance of these transactions and such treatments are inconsistent with the notions of tangible assets and intangible assets. Accordingly, most property leases should be scoped out of the* *revised ED and only certain exceptional transactions should be in the scope of the lease standard with on-balance treatment. In addition, for lease transactions that can be cancelled anytime by the lessee, the lessee should recognise lease payments in profit and loss on a straight-line basis over the lease term.*

(f) *Amortization of the right-of-use assets for Type B leases is back-loaded over the lease term. Comparing it to the amortization/depreciation method used for other non-financial assets (such as property, plant and equipment), which shall reflect the pattern in which the asset's future economic benefits are expected to be consumed, there is no theoretical justification to the amortization method under Type B and thus it would be inappropriate accounting. As a result of the amortization, the carrying amount of the right-of-use asset would have no meaning. In addition, this accounting would require very complicated calculation in practice.*

(g) *The requirements for impairment in IAS 36 should not be applied to right-of-use assets of Type B property leases because the right-of-use assets of Type B property leases have a different nature from those of Type A leases in that the entity's purpose of entering into Type B property leases is not to acquire the underlying asset.*

(h) *Regarding classification of leases, leases should be classified based on the IAS 17 (because the lease classification and accounting treatment in IAS 17 reflect economic substances of the variety of lease transactions properly). A lease transaction currently classified as finance leases should be classified as Type A leases under the revised ED. With regard to lease transactions currently classified as operating leases, an entity should recognise lease payment liabilities on an undiscounted and recognise lease expenses on a straight-line basis over the lease term.*

(i) *In cases where the leased assets are non-core assets in an entity's business (that is, the amounts of the leased assets compared to the amount of the entity's total business assets is immaterial), the entity should recognise lease payments in profit and loss on a straight-line basis over the lease term rather than applying the proposed requirements.*