To: International Accounting Standards Committee

From: YASUMASA MATSUDA Legal counsel, Certified Public Accountant in Japan

# Responses to E.D. Lease

#### Preface

Submitting this comment about ED Leases, I stress the necessity to examine the statute concerning Leases, because lease transaction is commercial transaction in law.

International Accounting Standards Committee belongs to International Accounting Standards Committee Foundation, which was incorporated on February 6, 2001 as the no-profit-corporation in the State of Delaware in United States of America.

The Delaware State adopted 1990 version of Uniform Commercial Code (UCC) in mid 1990 era. Therefore, IAS must obey the UCC Article 2A as the state law. Moreover, US also promulgated in 1978 Federal Bankruptcy Act (Bankruptcy Code), and Section 365 of Bankruptcy Code also stipulates that Personal Property leasing is treated as executory contract. On above reason, I stress that IAS 17 Lease and this Exposure Draft, even though in accounting theory, must obey these legal stipulations.

In consideration of above matters, I submit following my opinions.

## 1. The stipulation of Uniform Commercial Code

UCC first promulgated in 1952. Nevertheless it lacked to consider the Equipment Lease which was created by United States Leasing Co., and promulgated by independent leasing companies, and adopted by many small and medium companies. In spite of rapid progress of commercial leasing transactions the court applied Chapter 2 sales or Chapter 9 secured transactions for analogy.

Therefore in 1987 UCC promulgated "Article 2A Leases", and on this occasion also amended Article 1 of general provision to distinguish true lease and disguised lease. But California State and New York State opposed some provision of 1987 UCC, so in 1990 some minor amend was inserted in 1987 version. Therefore, 1990 version of UCC has been adopted almost all the state in U.S.. The revision of Article 1 is now stipulate in Chapter1-203 as "Leases Distinguished from Security Interest", and cleared lease transaction as true lease when at the end of lease term, lessee is not allowed to take the

title of leasing item and obliged to return leasing item.

Moreover UCC Article 2A stipulates that the object of leasing transaction is "Goods", Article 2A stipulate in section 103 as fallow;

- (j) "Lease" means a transfer of the right to possession and use of goods for a term in return for consideration.
- (h) "Goods" means all things that are movable at the time of identification to the lease contract, or are fixtures (section 2A-309).

And also stipulate in section 104, "Leases Subject to Other Law".

- (1) A lease although subject to this Article, is also subject to any applicable;
- (a) certificate of title statute of this State (list any certificate of title statutes covering automobiles, trailers, mobile homes, boats, farm tractors, and the like).

In above stipulation, not only important aircrafts, ships but also real property leasing are not included in Article 2A Leasing. Moreover, in state of California, Article 2A Leasing was later adopted, and, Article 2A Leasing was named as "Provision 10; Personal Property Leasing".

Therefore, though the naming is "real property leasing", the stipulation of Article 2A Leasing does not apply, and applicable law is Landlord and Tennant in common law. Also in Japan, "Shakuchi and Shakuya Hou", not leasing act.

#### 2. The Provisions of "Finance Leases" in 2A-103(g).

As above mentioned, Article 2A Leases cleared the true lease against disguised lease (that is, at the end of lease term whether lease item has some residual value and lessee is obliged to return leased item to lessor). Moreover Article 2A stipulated the meaning of "Finance Lease".

Nowadays, many accounting standards stipulate that "Finance Lease" is equivalent to "Full Payout Lease" and all risks and rewards of lease item is transferred to lessee from lessor, as per SSAP 21 "Accounting for Leases and Hire Purchase Contracts".

Nevertheless, Article 2A stipulates "Finance Lease" in 2A-103 (g) as follows;

- (i) the lesser does not select, manufacture or supply the goods
- (ii) the lessor acquire the goods or the right to possession and use of the good in connection with the lease and,
- (iii) the lessee, before singing lease contract, entitled to obtain concerning promises, warranties, any disclaimers of warranties, etc. or lessee may communicate with the supplier and receive thereof.

The above stipulation of Finance Lease means that Finance Lease is a three party transactions composed of Lessor, Lessee and Supplier and delivery and warranties of leased item are performed by supplier.

On above construction with Finance Lease, the contract does not confer any liability on leased item against Lessor. Therefore the executory cost of leased item does not transferred from Lessor to Lessee, through lease payment. Article 2A-407 "Irrevoeal Promises = Finance Lease" stipulate above liability. Without supplier's promises, Lessor's avoidance of liabilities of warranties would be void or unconscionable.

## 3. Relationship between Lease rental and Present Value of leased item.

In accounting theory, it is advocated that Present Value of leased item is the total of the advocated minimum lease payment excluding executory cost such as the cost of maintenance and warranty liability. This theory also is very erroneous argument.

Suppose the caluculation of lease rental as follows;

Present Value: \(\pma10,000,000\) (including supplier's covenant of warranty and so on).and Lessor's cost (present value) with handling charge in lease term, insurance premium and tax, total \(\pma1,000,000\). Therefore Present Value is \(\pma11,000,000\).

n.(lease term) 60 month(5 years)

i.(monthly interest 0.667%) Annual interest 8%

Residual value ¥1,000,000

lease rental(PMT) pre payment(begin) ¥208,040

end payment(end) \$209,430

if lease term 48 months (4 years)

monthly interest 0.5% (annual 6%)

then lease rental(PMT) pre payment(begin) \(\frac{1}{2}38,657\)

end payment(end) ¥239,850

Lessee although may know the price between supplier and lessor before signing lease contract, above calculation would be very different, therefore to ascertain the executory cost and minimum lease payment is very difficult. This is to say that executory cost is not admitted and following exectory contract in insolvency law would be more appropriate.

### 4. The Provisions of US Bankruptcy Code

The Bankruptcy Code, promulgated in 1978, stipulates personal property leasing as executory contract. Section 365 of the Code stipulate that "Executory Contracts and Unexpired Lease", and treat Finance Lease(Personal Property Lease) as executory contract. The Code also treat real property leasing as executory contract, but distinguish the difference between personal property leasing and real property leasing.

That is; only residential property leasing is treated as parallel with personal property leasing and in Chapter 11 Reorganization, section 365 (d)(5), stipulate that trustee or debtor in possession must pay lease rental after 60 days from the application of reorganization, as per stipulated in lease contract, when the trustee(or debtor in possession) does not determine to assume or reject leas contract within 60 days. This treatment is promulgated for the speedy protection of lessor in lease contract.

Bankruptcy Code stipulate finance lease rental as executory contract and never admitted the concept of executory cost on accounting theory.

## My responses to ED Lease

## Question 1 Leases

Response Lease rental is treated as executory contract in law, therefore concept of accounting theory so called the right of use is not recognized.

Also in real property leasing, the privilege of right-to-use is not recognized in recent deflation period, because so called privilege of lease contract in real property regarded the difference between present continuing rental and current new rental, so the difference is diminished in real property leases. On the contrary, long term real property leasing is regarded negative right-to-use, because fixed lease rentals obliged to pay for a long term, invite great loss in depression period.

#### Question 2 Lessors

Response Lease transaction is three party transaction. Therefore, the warranty, maintenance and so on, concerning lease item is performed by supplier. Lessor's obligation is very minimum, only not disturb lesse's peaceful possession of leased item.

## Question 3 Short-term Leases

Response Short-term lease as proposed such one year lease term, is regarded as rental contract not finance lease.

#### Question 4 Definition of a lease

Response Current lease contract is called finance lease, that is personal property(Goods) leasing under UCC Chapter 2A Lease. Real property lease is not contained in current lease contract. IAS17 shall be amended to exclude real property

lease, even though real property lease regarded as operating lease.

## Question 5 Scope exclusions

Response IFRS's concept of lease contract contains real property lease. Real property lease must be excluded from equipment lease or personal property lease of Goods, as per UCC Article 2A Lease.

## Question 6 Contracts that contain service components and lease components

Response As mentioned above in question 4, financing lease contains service components of which is performed by a supplier of lease item and also lease rental include such component as explained in above calculation of lease rental.

Therefore, in financial theory the construction that through the payment of lease rental, the rinks and rewards of lease item are transferred from lessor to lessee, must also be excluded.

#### Question 7 Purchase Option

Response In finance lease, the redelivery of lease item at the end of lease term is fundamental obligation of lessee. Purchase option, if included in lease contract, makes lease contract as hire purchase, or disguised lease, so it must be excluded from true lease.

## Question 8 Lease term

Response In lease transaction, lease term is bargained by lessee and lessor, primarily on lessee's intent. Lessee may insist 4 year lease available on 8 year economic useful item and also 5% residual amount, intending fast amortizing. On the contrary, lessee may insist more long lease term, that is 8 years of useful period of lease item and also insist 20% residual amount to make lease payment more small amount and retain available reserve fund. Therefore, the lease term may be bargained by the parties, not by accounting theory.

### Question 9 Lease payments

Response If real property lease is excluded from finance lease, about all leas term of finance lease would be less than 10 years. Therefore the adjustment of lease rental would not be necessary. And also most financial lease contract does not stipulate the clause to amend lease payment. In Japan the amendment would occur only when upward change of Value Added Tax occurred (upward change from only 3% to 5%).

#### Question 10 Reassessment

Response As mentioned in question 8, 9, when real property lease is excluded from finance lease, then contingent lease rental would not appear, so there is no necessity to change lease rental or lease term.

## Question 11 Sale and Lease back

Response When real property lease transaction is excluded from finance lease or personal property lease, Sale and leaseback transaction would not be necessary.

In Japan, automobile sale and leaseback transactions appeared in some entities, but automobile is subject to legal statute, so the leaseback transactions were made only for proper economic purpose, and it never came into trouble. On the contrary, lease back transaction may happen when the owner of real property is in need of capital, the transaction is recorded in Registry Book. So outside party is not misleaded by the transaction.

## Question 12 Statement of Financial Position

Response Lease payment is regarded as executory contract, that is, only when lease rental is paid, that counter benefit of use of lease item is recognized. Before payment of lease rental, any asset such as right-to-use is not recognized even in accounting theory.

## Question 13 Comprehensive Income

Response As above statement of Financial Position, in Japan comprehensive income is regarded the short time profit not a substantial profit. Excluding consolidated financial statement of listed company, more than 90% of general corporation do not adopt this accounting standard. Moreover I cannot understand why comprehensive income approach is necessary in lease transaction.

IAS should exclude this comprehensive approach also with disregarding real property leasing.

#### Question 14 Statement of cash flows

Response In short term finance lease or personal property lease, the concept of right to use is not recognized. Payment of lease rental may be outflow of cash but elaps of leas term may not necessarily bring profit to increase cash flow.

## Question 15 Disclosure

Response In Japan, disclosure of lease transactions on consolidated financial statement of listed company in 2010 year period were very small.

The phenomenon was futured by decreasing price of equipment such as computer and also by economic depression. Therefore, on balancing of leas transaction is not necessary and footnote presentation is more convenient for small and medium size companies.

### Question 16 Transition

Response As I have mentioned many times on above question, first of all the withdrawal of real property leasing from finance lease shall be applied immediately and then determine if necessary to make disclosure on balance sheet.

## Question 17 Benefit and costs

Response I think that finance lease transaction without real property leasing and disguised lease do not invite onbalance approach. Therefore general small and medium company shall not be obliged to disclose lease transactions on balance sheet with too much cost.

#### Question 18 Other comment

Response On above my response, I stressed to examine statute law on lease transaction such as UCC and Bankruptcy Code in U.S. of which country IASC Foundation belongs.

IASC shall not be self-righteous to lead international nations. Remember that in 1988, Unidroit Leasing Treaty was promulgated, but U.K. and U.S. did not adopt this treaty. Recently United Nations promulgated the Convention on Contracts for the International Sale of Goods(1980). But unfortunately U.K. does not adopt this treaty. I hope IASC shall not follow these attitude. And my last comment is that my Japanese response may be accepted with this English response, if IASC is preparing to open East branch in Tokyo.