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Accounting & Tax Committee Japan Foreign Trade Council, Inc.

To the International Accounting Standards Board

Comments on "Leases"

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) made in response to the solicitation of comments regarding the International Accounting Standards Board Exposure Draft "Leases". The JFTC is a trade-industry association with trading companies and trading organizations as its core members, while the principal function of its Accounting & Tax Committee is to respond to developments in domestic and international accounting standards. (Member companies of the Accounting & Tax Committee of JFTC are listed at the end of this document.)

I. General Comments

From the perspective of enhancing the usefulness of financial statements, we agree with the IASB's basic position that "an entity should recognize assets and liabilities arising from a lease." However, some proposals have been made for revision of the 2010 Exposure Draft, including revision of on-balance-sheet accounting and disclosure, which we believe will entail considerable onerousness for preparers. Therefore, we request that careful consideration be given to the practicality and the costs and benefits of these proposals.

We do not oppose recognition of and on-balance-sheet accounting for a lessee's right of use. On the other hand, classification of leases and income/cost accounting proposed in the revised ED do not necessarily faithfully reflect in term costs the economics of lease transactions other than property leases. Whereas lease classification criteria consist of lease term and significance of lease payments relative to the portion of the underlying asset to be consumed, assessment of these criteria should be such that accounting standard does not distort the original intent and purpose of lease transactions. For this purpose, provisions should be made to permit preparers of financial statements to appropriately classify lease transactions in line with the purpose and economics of each transaction.

We are concerned that lessor accounting for unearned profits on residual assets and certain disclosure requirements may require revision of systems that will prove to be excessively burdensome and costly to preparers of financial statements. In light of this, we request that due consideration be given to the costs and benefits in formulating the standard.

The revised ED contains no specific reference to the effective date. Considering the practical steps that preparers of financial statements must take, we request that sufficient time to be established between the release and the effective date of the standard.

II. Specific Issues (Responses to Questions)

Question 1: Identifying a Lease

(Response)

We agree with the proposal.

(Reason)

We do not see any problems in the definition of leases contained in the revised ED.

Question 2: Lessee Accounting

(Response)

We agree with the proposal, but request further consideration of the matters listed below.

(Reasons)

- (1) The revised ED permits off-balance-sheet accounting for "short-term lease". We appreciate this as a practical relief based on the thinking that such leases have a very low likelihood of giving rise to material assets or liabilities (paragraphs BC296 and BC297).
- (2) As discussed below, there are some problems with Type B leases. However, the merit of Type B leases is that there would be no change in profit or loss for property currently being leased under an operating lease.

(Matters for Further Consideration)

(1) We believe the criterion of significance applicable to short-term leases may be extended to small lease contracts without overly

inconveniencing users of financial statements. For small lease contracts, especially those where it is clear that the lease payments do not give rise to material lease assets or liabilities, we believe it is necessary to take further steps toward administrative burden reduction, for example, by permitting off-balance-sheet accounting for such leases as in the case of short-term leases.

(2) Unclear criterion is given for the provision, "whether the lessee is expected to consume more than an insignificant portion of the economic benefits." We believe that quantitative criteria should be provided or that the provision should be reworded for greater clarity. In particular, in the case of non-property leases, consuming more than an insignificant portion should be defined to be, at least, consumption of 50 percent or more. We believe this would be closer to the understanding of entities. (The same applies to Question 3 as well.)

(3) Problems of Type B leases

- (i) Right-of-use assets are classified as amortizable nonfinancial assets. Therefore, to ensure consistency with amortization of nonfinancial assets, it is desirable to use amortization methods based on consumption.
- (ii) Calculation of amortization charges of right-of-use assets recognized for Type B leases is not based on the consumption of assets, and thus distorts the lessee's amortization charges. Moreover, the carrying amount of right-of-use assets derived in this manner is void of any accounting significance.
- (iii) Establishing the multiple models consisting of Type A and Type B leases may undermine comparability by permitting different accounting for similar transactions. Taking this into consideration, it would be ideal to account for leases under a single model.

Question 3: Lessor Accounting

(Response)

We do not agree with the proposal.

(Reason)

(1) Accounting for Type A leases differs significantly from current accounting. (In particular, unwinding the discount on residual assets in which interest from nonfinancial assets is recognized and added to the carrying amount is incompatible with the current accounting framework.) This different approach will significantly increase the complexity and cost of preparing financial statements, in addition, it is difficult to apply in practice.

(Proposal for Alternative Approach)

Current finance lease accounting provides a good reflection of business and has not been the source of any major problem in management control. Therefore, with regard to accounting for Type A leases, we request that the current finance lease accounting for lessors under IAS 17 be retained.

Question 4: Classification of Leases

(Response)

We agree with the proposal, but request further consideration of the matters outlined below.

(Matters for Further Consideration)

- (1) Whereas leases are to be classified based on lease term and significance of lease payments relative to the portion of the underlying asset to be consumed, preparers of financial statements should be permitted to appropriately select a lease classification that corresponds to the purpose and economics of a lease transaction. In particular, Illustrative Example 12 pertaining to the classification of equipment leases effectively hints at how the standard may be interpreted in assessing the significance of the portion of the underlying asset to be consumed. As a result, many lease transactions would be treated similarly to financial transactions. However, lease transactions are not necessarily structured with a view to financial transactions, and we strongly fear that this accounting standard would distort the original intent and purpose of lease transactions. Therefore, we request that this illustrative example be deleted from the standard.
- (2) Such expressions as "insignificant," "substantially all," and "major part" render the criteria ambiguous. To facilitate application, we believe it is necessary for the boards to provide additional guidance in the form of, for example, clearer expressions or numerical criteria.

Question 5: Lease Term

(Response)

We do not agree with the proposal.

(Reasons)

(1) We understand the theoretical rationale for the proposal for reassessing the lease term. However, from the perspective of the costs and benefits, the added complexity would give rise to an excessive burden in application.

- (2) Regarding measurement of the maximum possible lease term, consider a lease contract with an option to extend the lease term beyond 12 months. Unless the exercise of such an option is subject to the consent of the parties to the lease, the possible lease term of the original contract will be interpreted to exceed 12 months. This leads us to believe that in practice, very few lease contracts would be deemed to constitute short-term leases. As a result, a majority of lease transactions would require recognition of right-of-use assets and lease liabilities. We fear that from the perspective of the costs and benefits, this would increase the administrative burden on preparers of financial statements.
- (3) In certain cases in Japan, the renewal of a property lease contract requires one of the parties to submit prior notification to the other before maturity of the contract. Because post-renewal rent is agreed upon based on market value at time of renewal, pre- and post-renewal rents may differ. In such cases, should the maximum possible lease term be estimated at the commencement of the contract by recognizing the renewal of the contract as an option to extend the lease or should the renewal be deemed a new lease contract? Because lease classification and accounting will differ according to the choice made, we request that in the standard, clear guidance and illustrative examples be provided on treatment of the renewal of property lease contracts.
- (4) An option to extend the lease is to be included in the lease term if there is a significant economic incentive to exercise that option. However, this is too abstract and may undermine comparability of financial statements among entities. While paragraphs B5 and B6 provide for assessment of economic incentives, these provisions allow for considerable discretion in such areas as assessment of all relevant factors and reassessment when those factors have changed. Moreover, we believe these provisions entail considerable burdens in application.

Question 6: Variable Lease Payments

(Response)

We agree with the proposal, but request further consideration of the matters below.

(Reason)

We believe reassessment is necessary for properly reflecting lease-related cash outflow in financial statements.

(Matters for Further Consideration)

Regarding reassessment of lease liabilities and lease receivables following revision of lease payments, in view of cost to preparers, we request that explicit mention be made that no reassessment will be required for insignificant changes in an index or a rate. Specifically, we request that wording be included in paragraphs 43 and 78 indicating that only significant changes to lease payments will need to be reflected in lease liabilities and lease receivables.

Question 7: Transition

(Response)

We do not agree with the proposal.

(Reason)

Although certain reliefs have been permitted, including a simplified retrospective approach, administrative burdens remain high in general.

Reasons for Not Agreeing with Individual Matters

- (1) Regarding operating leases, the administrative burden of reclassification and remeasurement is extremely high.
- (2) Lessee or lessor accounting for transition from operating leases to Type A leases
 - (a) Regarding lessee accounting for transition from operating leases to Type A leases, for example, it can be assumed that large numbers of office equipment leases will come under this pattern. For this reason, implementation of the proposed procedures will involve excessive administrative burdens.
 - (b) Regarding lessor accounting for transition from operating leases to Type A leases, as in (a) above, it can be assumed that large numbers of office equipment leases will come under this pattern. For this reason, implementation of the proposed procedures will involve excessive administrative burdens. Requiring measurement of fair value for each individual asset at time of transition and after maturation of the lease is unrealistic.

(Alternative Proposals for Transition)

- (1) We request that more simplified approaches should be permitted. For example, one option would be to apply the new standard only to contracts concluded after the effective date. Another option would be to apply the new standard to existing contracts as well, but to allow prospective application after the effective date.
- (2) Lessee or lessor accounting for transition from operating leases to Type A leases

- (a) As in the case of accounting for transition from operating leases to Type B leases, the right of use should be permitted to be recognized as being equivalent to the value of the lease liability. (Administrative burdens would be significantly reduced if the demarcation of Type A and Type B leases other than property leases were to be reviewed.)
- (b) We believe simplified approaches are necessary, such as the exclusion of small or noncore leases, or defining the carrying amount of residual assets as the amount obtained by subtracting lease receivables from the carrying amount of the lease asset.
- (3) Transition measures for reducing administrative burdens should be considered, such as permitting the application of current accounting methods to small lease contracts, and to lease contracts involving significant amounts at time of contract but with small residual lease payments outstanding at transition date.

Question 8: Disclosure

(Response)

We do not agree with the proposal.

(Reasons)

Overall, the administrative burden for preparers of financial statements is high, and the usefulness of disclosure is unclear. We believe the information to be disclosed requires further examination. To avoid excessive burdens on preparers of financial statements, consideration should be given to an appropriate balance between administrative and cost burdens to preparers, and usefulness to users. Moreover, in the light of the fact that on-balance-sheet accounting for lease-related assets and liabilities was introduced for the purpose of ensuring the transparency of financial information, disclosure requirements should be eased from present levels; nevertheless, the proposed requirements would entail extremely heavy administrative burdens.

Reasons for Not Agreeing with Individual Matters

(1) Maturity analyses of undiscounted lease payments

Regarding maturity analysis of lease receivables and lease liabilities, the current standards do not require disclosure of annual amounts for contracts with maturity of more than one year and up to five years. For this reason, we believe the disclosure requirements of the revised ED are excessively burdensome, and that this proposal is especially unacceptable.

- (2) Reconciliations of amounts recognized in the statement of financial position
 - (a) Taking into account that similar disclosure requirements do not apply to other financial assets and liabilities, we believe it is excessive to apply this requirement to lease receivables, lease liabilities, and other items, and that this proposal is especially unacceptable. Moreover, this requirement places an excessive administrative burden on preparers of financial statements.
 - (b) The usefulness of disclosure is unclear. Furthermore, preparers of financial statements should not be required to make additional disclosures simply for the purpose of improving usefulness for users of financial statements.
 - (c) Even if disclosure of a reconciliation of opening and closing balances of lease assets and lease liabilities were to be mandated, we believe disclosure of a reconciliation of lease liabilities by class (Type A and Type B) to be unnecessary. As stated in paragraph BC204, the nature of a lease liability does not differ on the basis of the nature of the underlying asset to which it relates. Therefore, disclosure by class is of limited significance and would entail excessive administrative burdens on preparers of financial statements.

(3) Narrative disclosures about leases

We believe cost to preparers of financial statements will exceed the benefit to users. Therefore, we request that consideration be given, for example, to restricting this requirement to significant lease contracts.

(4) Others

(a) Information about leases that have not yet commenced but that create significant rights and obligations for the lessee

The definition of "significant" and the information to be disclosed are unclear. Moreover, we believe there would be very few cases of actual disclosure, and conclude that this disclosure would be of limited significance.

(b) Disclosure of fair value of right-of-use assets arising from Type B leases of investment property

Regarding investment property lease transactions that are currently accounted for as operating leases, requiring disclose of fair value of right-of-use assets arising from Type B leases of investment property would entail excessive burdens on preparers of financial statements. We request that this requirement be deleted for the costs and benefits reasons.

(Alternative Proposal on Disclosure)

- (1) Guidance should be added permitting entities for which a particular disclosure is of limited significance to omit that disclosure.
- (2) We request that further consideration be given to disclosure requirements from the perspective of administrative and cost burdens to preparers of financial statements and usefulness to users. For example, we request consideration of such proposals as restricting the disclosure of qualitative information to significant lease contracts, and requiring disclosure of closing-balance breakdown instead of reconciliations.

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

(Response)

We agree to including right-of-use assets arising from a lease of investment property in the scope of IAS 40. However, we request that disclosure of fair value of right-of-use assets arising from Type B leases be excluded.

III. Other Comments

We request that the following point be considered.

• In sublease accounting, suppose that both the head lease and the sublease constitute Type A leases. In this case, the right-of-use asset in the head lease is interpreted to constitute an underlying asset that is derecognized under the sublease. As this matter is not clearly indicated in the proposal, we request inclusion of an explicit statement to this effect in the standard.

Japan Foreign Trade Council, Inc.

World Trade Center Bldg. 6th Floor, 4-1, Hamamatsu-cho 2-chome, Minato-ku, Tokyo 105-6106, Japan URL. http://www.jftc.or.jp/

Members of the Accounting & Tax Committee of JFTC

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