

The Real Estate Companies Association of Japan  
Kasumigaseki Building 17th floor, 3-2-5 Kasumigaseki  
Chiyoda-Ku, Tokyo 100-6017 Japan  
Phone: +81-3-3581-9421

December 15, 2010

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir or Madam:

### **Comments on Exposure Draft “Leases”**

The Real Estate Companies Association of Japan (“Association”) appreciates the efforts of the International Accounting Standard Board (“IASB”) and the Financial Accounting Standards Board (“FASB”) on the project on lease accounting.

This document contains the Association’s comments on the exposure draft “Leases” for your review and consideration.

The comments are arranged in a manner that details our view on each question indicated in the exposure draft.

#### **Question 5: Scope exclusions**

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

The Association does not agree with the proposed scope. The lessor accounting for leasing of investment property should be excluded from the scope of the proposed IFRS regardless of whether

the investment property is measured at fair value in accordance with IAS 40 or measured at cost. Furthermore, the lessee accounting for leasing of real estate in general (i.e., not just investment property) should also be excluded from the scope of the proposed IFRS.

Reason:

1. Lessor of investment property

- (1) The contractual term of individual real estate leases in Japan is significantly shorter than the useful life of the underlying property (2 to 5 years in general). These leases naturally involve uncertainty in future contract renewals, possibility of lease termination before the expiration of the lease term, and uncertainty in the estimation of lease payment revisions. As such, estimation of “lease term (options to cancel or renew)” and “rentals (including revised rentals at the time of lease renewal and contingent rentals such as rentals of retail property that are based on a specified percentage of sales)” requires significant administrative burden, and yet it is difficult to ensure reliability of the estimates. Therefore, the administrative burden arising from implementing the proposed model does not justify the costs.
- (2) “Comparability” cannot be secured as estimation mentioned above inherently involves judgment (discretion) by each preparer. Furthermore, the proposed model may provide an opportunity for earnings management and is highly unsatisfactory from the perspective of securing accounting treatment consistency.
- (3) The exposure draft proposes a model that requires the lessor to estimate future cash flows of individual lease contracts with tenants (current tenants) as of the end of the year and present the discounted present value of these cash flows in the statement of financial position. However, the Association expects that the users of financial statements are primarily interested in the present value of cash flows “generated by the underlying property in future periods” rather than the present value of cash flows arising from the “current tenants”. In fact, this information is nearly equal to the “fair value” of the underlying property and fair value of investment property is already required to be presented on the face of the financial statements or in the notes thereto in accordance with IAS 40 (Investment Property). Therefore, there will be very little extra benefit in requiring similar information to be presented on the face of the financial statements or in the notes thereto under the lease accounting standard.
- (4) The real estate leasing business conducted by real estate companies in Japan is based on a business model of long-term asset (real estate) holding and value enhancement, aiming at achieving stable and increasing income. However, according to the model proposed by the

exposure draft, much of the income gains arising from investment property, which is income from the core business of a real estate company, would be classified as “interest income” in the statement of income rather than “operating income” as if it were from a non-core business. Moreover, as “interest income” is calculated under the effective interest method, the largest income is recognized at the start of the contract and the amount of recognized income would steadily decrease thereafter. This income recognition pattern is significantly different from the pattern of actual rental cash flows and would not faithfully reflect the economic substance of the business. “Investment property” has characteristics that are different from those of “financial instruments”. Treating investment property in the same manner as in the accounting model more appropriate to the general leasing business, which is a type of financing business with certain features to provide an alternative means to purchase or a financing function, and requiring the interest income calculation mentioned above would not be useful to the users of financial statements.

## 2. Lessee of real estate

(1) A distinctive characteristic of real estate is that each property has extremely individual and irreplaceable nature. Therefore, unlike the case of a lessee in a lease of depreciable assets, a lessee in a lease of real estate does not enter into the lease contract for the purpose of using it as an alternative means to purchase real estate or financing the purchase of real estate.

In the first place, since leasing of real estate provides the following unique advantages that cannot be achieved through purchasing, the lessee is presumed to have selected leasing as opposed to purchasing positively as a means to use real estate:

- The floor area and the location can be changed flexibly depending on the economic environment or the financial performance of the lessee. As a result, leasing has an effect of minimizing business risk;
- Leasing provides many options in terms of location and space. Especially in an inner urban area, it is extremely difficult to purchase an office building with necessary specifications when necessary; and
- A high level of property maintenance and management know-how can be expected for the space used by the lessee especially when the lessor is a professional real estate operator.

As a result, in order to meet the objective, as indicated in the exposure draft, of reporting “relevant and representationally faithful information to users of financial statements about the amounts, timing and uncertainty of the cash flows arising from leases”, an accounting model based on the perspectives of “flexibility”, “liquidity”, “non-restrictiveness”, etc., will be able to present more faithful information than an accounting model based on the

perspective of “how to recognize and record assets and liabilities”. Therefore, except in the case of real estate leases that fall under the category of finance lease under the current standard, operating lease accounting for lessees will provide the least misleading and the most useful information on real estate leases to the users of the financial statements and present most faithfully the economic substance of the business that relies on the leasing of real estate. Presenting assets and liabilities associated with these leases in the statement of financial position would rather obscure the economic substance.

- (2) If real estate leases would be included in the scope of the exposure draft, the rental expenses to be paid by the lessee would be divided into principal repayments and interest expenses. However, classifying and recognizing as “finance charges” the act of paying consideration for the use of office or other spaces in the course of the lessee’s actual business activities would not faithfully present the economic substance of the business.

Furthermore, the largest expenses would be recognized at the start of the contract and the amount of recognized expenses would steadily decrease thereafter. This expense recognition pattern is significantly different from the pattern of actual rental payment cash flows and would not meet the needs of the users of the financial statements.

- (3) The leasing of an office building represents a “required cost” in terms of tenants’ intellectual production activities and resembles the purchase of raw materials and the purchase of energy supplies as part of a factory production activity in that both are naturally necessary and essential for production.

Essentially, there is no requirement to recognize a liability at present value for purchasing raw materials and purchasing energy supplies as part of a factory production activity just because these activities involve “future cash outflows”.

In terms of the ongoing responsibility to provide for the satisfaction of a performance obligation, there is no difference between the receipt of goods and services in a multi-year contract for purchasing raw materials and purchasing energy supplies and the leasing of office space under a multi-year contract as the related “required cost” for an intellectual production activity.

In such cases, each year’s recognition of expense to the extent that goods and services are received (i.e., fulfillment of the performance obligation) reflects the economic substance more appropriately. The initial recognition of the present value of the asset and subsequent recognition of expenses as depreciation for such an asset does not faithfully show the economic substance of this type of transaction.

Recognizing a liability based on the “estimation” of future renewal options and contingent

rentals leads to the recognition of liabilities for non-occurring or non-existent and uncertain obligations. Such recognition therefore creates problems in light of accounting treatment consistency.

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

(As indicated in the comments to Question 5, the Association believes that lessor accounting for leases of investment property and lessee accounting for leasing of real estate in general should be excluded from the scope of the proposed IFRS. Therefore, the following comments reflect our view on accounting requirements related to lease term that should be applied to lessor accounting for leases of investment property and lessee accounting for leasing of real estate in general, if they should be included in the scope despite our comments on scope exclusions.)

The Association does not agree with the proposed approach.

Reason:

With respect to the estimation of lease term, we observe the existence of a trade-off relationship between the efforts to correct “understatement of assets and liabilities (particularly with regard to operating leases)”, which is cited as one of the recognized issues that led to the issuance of the exposure draft, and the efforts to secure accounting treatment consistency.

In such cases, the priority should be placed on securing accounting treatment consistency, eliminating arbitrary accounting treatment, and securing comparability. Lease term should be limited to something that is clear and certain (e.g., non-cancelable term of the lease).

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

(As indicated in the comments to Question 5, the Association believes that lessor accounting for

leases of investment property and lessee accounting for leasing of real estate in general should be excluded from the scope of the proposed IFRS. Therefore, the following comments reflect our view on accounting requirements related to lease payments that should be applied to lessor accounting for leases of investment property and lessee accounting for leasing of real estate in general, if they should be included in the scope despite our comments on scope exclusions.)

The Association does not agree with the proposed approach.

Reason:

As contingent rentals cannot be estimated reliably, they should be recognized as income or expense when their timing and amount have become certain (i.e., current operating lease accounting)

Question 15: Disclosure

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

(As indicated in the comments to Question 5, the Association believes that lessor accounting for leases of investment property and lessee accounting for leasing of real estate in general should be excluded from the scope of the proposed IFRS. Therefore, the following comments reflect our view on disclosure requirements that should be applied to lessor accounting for leases of investment property and lessee accounting for leasing of real estate in general, if they should be included in the scope despite our comments on scope exclusions.)

The Association does not agree with the proposed disclosure requirements.

Reason:

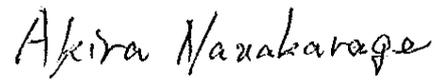
From the perspective of difficulties involved in the estimation of lease term (options to cancel or renew) and future rentals (including rental revisions and contingent rentals) and securing the reliability thereof, the proposed disclosure of maturity analysis in the notes to the financial statements should not be required.

\* \* \* \* \*

We hope that our comments will contribute to the forthcoming deliberations in the project.

If you have any questions concerning our comments, please contact Mr Tobita at [tobita@fdk.or.jp](mailto:tobita@fdk.or.jp)

Sincerely,

A handwritten signature in black ink that reads "Akira Nanakarage". The script is cursive and fluid, with the first letters of each word being capitalized and prominent.

Akira Nanakarage  
Secretary-General