Document No. 292  
December 14, 2010  

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" (hereinafter ED). 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 JFTC’s Accounting & Tax Committee are listed at the end of this document.)  

I. General Comments  

We believe this ED to be highly significant in that it applies the right-of-use model to lease accounting of lessees and thereby requires operating leases under current standards to be recognized in the statement of financial position and enhances the usefulness of financial statements.  

However, the proposals of the ED contain various points that will be difficult to implement from a practical point of view. These points, together with disclosure requirements, should be subjected to further careful examination and discussion from a cost-benefit perspective.  

II. Specific Issues (Comments on Questions)  

Question 1: Lessees  

In principle, we agree with the proposal. However, in the following cases, a lessee should not recognize right-of-use assets and liabilities to make lease payments.  

(1) Short-term leases  

See our response to Question 3.  

(2) Leases that can be cancelled at any time  

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In the case of leases that can be cancelled at any time without significant penalty, future payments can be avoided depending on an entity’s decisions and actions. As such, such leases do not satisfy the IAS 37 definition of liability as “present obligation” (see Example 11B of IAS 37), and it would be inappropriate to recognize them as liabilities. We believe that such leases should be subject to the current accounting standards for operating leases.

(3) Leases whose costs are included in SG&A expenses

We are not opposed to applying the proposed standard to cases where the cost of the underlying asset is included in cost of sales because activities related to the asset are interpreted to be indispensable to the principal business of the entity. However, in cases where the cost of the underlying asset is included in SG&A expenses, the conventional principle for operating leases (accounting for rental transactions) should remain acceptable.

(4) Cases where the intermediate entity in a sublease effectively bears no risk and derives no economic benefit from the underlying asset

Consider the following case involving the sublease of aircraft. Assume that a head lease and sublease are contracted as components of a single transaction where all the benefits and risks related to the lease, such as the credit risk of the final lessee (airline company) and warrantee against defects of the underlying asset, are assigned to the lessor under the head lease (owner); and that the intermediate entity does not carry any such risks and benefits in relation to the lease. Moreover, the intermediate entity effectively acts solely as lease intermediary and receives only a very small remuneration in the form of a margin on the lease payments. (In other words, the intermediate entity receives a sublease payment that consists of a head lease payment plus a very small add-on fee.) In this case, the intermediate entity is a party to a service contract, but effectively is not a party to the lease contract and cannot be said to hold the right to use the underlying asset. Therefore, it would be inappropriate to recognize a right-of-use asset. We believe such cases should be subject to the current accounting standards for operating leases.

(5) Time-charter contract in the shipping industry

Time-charter contracts for vessels in the shipping industry are not so much an alternative means to raise funds as they are a “contract for the provision of services” wherein the vessel owner provides the chartering entity with a service that takes the form of cargo transportation. We believe that recognizing these contracts as assets and liabilities in statement of financial position would not properly reflect the economic reality of the transaction.
**Question 2: Lessors**

We are opposed to the adoption of the performance obligation approach for the following reasons.

(1) The performance obligation approach is conceptually inconsistent. It assumes the lessor has not fulfilled its performance obligations on the residual portions of the lease. On the other hand, the approach requires the lessee to recognize a liability on these unfulfilled performance obligations of the lessor, and assumes that the lessee has obtained the right of use.

(2) Net lease asset value does not represent the residual book value of the underlying asset and provides no useful information to preparers and users of financial statements. Normally after the start of a lease, residual rights to receive lease payments and residual lease liabilities are unequal. Consequently, the lessor's net lease asset value normally does not equal the residual book value of the underlying asset. The net lease asset value that is ultimately recorded in the statement of financial position has no meaning other than being the simple sum of the residual of the underlying asset, residual rights to receive lease payments, and residual lease liabilities. We do not think that this information would be useful to preparers and users.

For example, in aircraft leasing contracts, it frequently occurs that the lessor sells the underlying asset to the customer before the end of the lease term. In such instances, the proposal would result in an unreasonable situation. That is, because the cost of sales differs from the residual book value of the underlying asset at the time of sale, the profit or loss from the sale of the underlying asset would differ from the profit or loss registered from the sale of a tangible fixed asset that does not involve a lease contract but is conducted under exactly the same terms (the same acquisition cost, service life, number of years in use, etc.). This is highly inconvenient from the perspective of management control and also undermines comparability among entities.

The following counter-argument to our position can be anticipated. Under the ED proposal, when the leased asset is sold before the end of the lease term, the date of sale should be used as the end of the lease term so that the rights to receive lease payments and lease liabilities converge at zero at the time of sale, ensuring that the net lease asset value equals the residual book value of the underlying asset. This counter-argument, however, contains the following problems and is not valid. The time of sale cannot be fully predicted in advance because the sale of the underlying asset is determined in light of changing market conditions and options available to the customer. This means that differences between net lease asset value and residual book value of the underlying asset are inevitable. (Moreover,
as indicated in our response to Question 8, we oppose the ED proposal concerning determination of the lease term.)

(3) Normally, we would expect symmetry to be maintained between lessee accounting and lessor accounting. However, under the ED proposal, lessee accounting would be unified, while two different treatments would be available to lessors, creating a significant asymmetry between lessee and lessor accounting.

(4) One of the objectives of the ED is to abolish the existing distinction between finance leases and operating leases (paragraph BC6(a)). We believe that the proposed distinction based on whether a lessor retains exposure to significant risks or benefits associated with the underlying asset under the performance obligation approach and the derecognition approach not only runs counter to this stated objective and makes accounting more complex, but also involves significant practical difficulties.

We believe the derecognition approach is appropriate in lessor accounting for the following reasons. The lessee recognizes right-of-use assets as if they were tangible assets (paragraph 25(b)). From the perspective of maintaining symmetry with lessee accounting, we believe the lessor should derecognize the corresponding asset. Moreover, considering the proposed definition of lease as a “contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration,” a lease restricts the lessor’s ability to use the underlying asset for a period of time and thereby causes the lessor to forgo control of the asset, albeit temporarily. Therefore, we believe derecognition to be appropriate. Similarly, we believe the derecognition approach is more appropriate because the asset should be derecognized at least for the loss of benefit resulting from the restriction of use.

For the derecognition approach, the ED states (paragraph 55) that the residual asset should not be remeasured unless the lease term has been changed or the residual asset is impaired. As no reference is made to the need for depreciation in this context, we believe an explicit statement should be included in the standard indicating that depreciation is not necessary.

In the event that our above proposal is not adopted and distinction based on the performance obligation approach and derecognition approach is adopted as proposed in the ED, we find the guidance contained in paragraphs B22–B27 for choosing between the two approaches to be too abstract and inadequate for practical application. Therefore, we request that clearer practical guidelines be provided for the two approaches.
Question 3: Short-term leases

Regarding lessee accounting, we oppose the ED proposal for the reasons outlined below. Instead, we believe that accounting for rental transactions should be accepted as a simplified accounting method.

(1) For the lessee, even a very short-term lease with a duration of only a few days would have to be entered under assets and liabilities. (In the very least, the lessee would have to consider the significance of the amounts involved.) Even if discount calculation is not required, this would entail an excessive administrative burden for entities holding large numbers of lease contracts. On the other hand, information on short-term leases has very little importance for users interested in forecasting the entity’s future cash flows. This indicates that the expected benefits would not justify the costs associated with this proposal.

(2) We appreciate the concern that establishing a quantitative criterion of “twelve months” opens the way to arbitrary manipulation by entities. However, this problem can be properly addressed through rules related to determination of lease term. Specifically, it can be stipulated that the option to renew the lease term shall be taken into consideration only in cases where it is clearly deemed at inception that the option to renew will be exercised (see our response to Question 8). Moreover, suppose that the option to renew must always be taken into consideration. In this scenario, the importance of recognizing the lessee’s right of use as an asset would be even further reduced in cases where the lease term remains within twelve months after taking into account the option to renew.

(3) The ED proposal allows a lessor to recognize lease payments from short-term leases in profit or loss instead of recognizing the assets and liabilities generated by short-term leases in the statement of financial position. The availability of this simplified treatment undermines symmetry between lessee and lessor accounting. It is our position that the lessee should be provided with the same simplified option of recognizing lease payments from short-term leases in profit or loss instead of recognizing the assets and liabilities generated by short-term leases in the statement of financial position.

Question 4: Definition of a lease

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In principle, we support the definition. However, please refer to the views expressed in (b) and (c) below.
(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

The following views were received from members of the JFTC. Matters related to the definition of a lease have not yet been fully discussed and further careful examination is necessary.

(1) The proposed criteria for distinguishing between a lease and a contract that represents a purchase or sale should not be supported. With regard to lessor accounting, it is appropriate to allow for only the derecognition approach. Because the recognition of right-of-use assets in lessee accounting and derecognition of the underlying asset in lessor accounting are equivalent to the accounting of contracts representing a purchase or sale, there is very little significance in rendering a judgment on whether or not a lease contract is equivalent to a contract representing a purchase or sale.

(2) The proposal should be supported. However, clear guidance should be provided on cases in which the lease term covers almost the entire service life of the underlying asset and cases involving full-payout leases. In other words, clarification is needed on the distinction between zero-residual lease contracts to which the derecognition approach has been applied and contracts representing a purchase or sale. Furthermore, clear guidance is needed on “all but a trivial amount of the risks and benefits” when a contract is deemed to represent a purchase or sale.

c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

The definition is inadequate. The clause “ability . . . to direct others to operate the asset in a manner that it determines” (paragraph B4(a)) is open to a wide range of interpretations and will cause confusion. Illustrative examples should be provided on this point. Guidance should also be provided on specific types of transactions as given in IFRIC 4.

**Question 5: Scope exclusions**

We do not support the proposal. The discontinuation of IAS 17 will leave no standard for the treatment of leases of intangible assets. The scope of the proposed standard should include leases of intangible assets.
Question 6: Contracts that contain service components and lease components

We support the FASB proposal. The proposal to allocate lease payments between service and lease components and to subject these to different accounting standards when performance obligations cannot be distinguished on the basis of Revenue from Contracts with Customers is, in the final analysis, equivalent to distinguishing performance obligations. This seriously undermines consistently between standards and is inappropriate. In actual practice, it is frequently impossible to separate a contract that contains both service and lease components. Therefore, we deem the IASB proposal to be impractical.

Question 7: Purchase options

We agree with the proposal that a lessee or a lessor should account for purchase options only when they are exercised.

Question 8: Lease term

We oppose the proposal for the following reasons.

1) According to the ED proposal, an entity should take into account the lease term during which cancellation may be made and the renewal options even in cases where the exercise of these options is uncertain. Such matters, however, are stipulated in the contract primarily as a risk avoidance measure and it is not necessarily assumed that the entity will pursue either contract cancellation or renewal. The inclusion of these additional periods may, therefore, lead to an overstatement of assets and liabilities.

2) The probabilities presented in paragraph B17 may be reasonable from a theoretical perspective. However, in actual practice, we cannot imagine how these computations could be used. Suppose the computations of paragraph B17 were to be adopted. Normally, estimates would be based on average values derived from past experiences. However, there is no guarantee that an entity would be able to find a lease contract from its past that was entered into under exactly the same terms and conditions as the one on hand. Even if equivalent contracts existed in the past, reliability would be compromised if the number of such contracts were small. It is true that leasing companies would have a very large pool of past contracts to draw from. However, the problem is that significant changes would have to be made in recording and accounting systems to maintain data on actual lease terms and to apply this information to probability computations. Similarly, the task of individually estimating probabilities for a very large pool of lease contracts would entail excessive administrative burdens. Furthermore, the auditing cost of
validating these estimates would also be large. On the other hand, the expected benefits would not offset the costs.

(3) The recognition of receivables and liabilities based on estimated values is very likely to invite arbitrary adjustment of amounts based on business performance.

We appreciate the concern that some entities may intentionally set short lease terms and repeatedly exercise the renewal option as a means for deliberately underreporting assets and liabilities. However, this problem can be properly addressed by adopting the following stipulation. First, the lease term should, in principle, be defined to be the contractual lease term. Second, the option to renew should be taken into account exceptionally, only when it is clearly deemed at the inception that the option to renew will be exercised. Regarding the deliberate repetition of the option to renew, a clear judgment can be made based on the provisions of paragraph B18.

**Question 9: Lease payments**

We are opposed to using the expected outcome technique for the following reasons.

(1) Consider contingent rentals and other instances where the lease contract contains uncertainty. In such cases, instead of computing the weighted average value of expected outcomes, the majority of entities would simply use minimum lease payments to estimate lease payment amounts. To require across-the-board computation of expected outcomes notwithstanding this fact would result in the measurement of lease payment amounts that are totally at variance with the intent of the entity. This would undermine the usefulness of financial statements.

(2) As outlined below, any effort to compute expected outcomes would result in excessive administrative burdens. First, with the exception of objective data that can be obtained from external sources, estimates would have to be based on internal records from the past. This gives rise to the same problems that were mentioned in our comments on lease terms (Question 8). That is, estimation would either be impossible due to lack of sufficient data from the past, or would yield unreliable results. Second, because lease payments would be computed based on multiple formulas, this would in some cases give rise to very large administrative burdens. While this approach would entail excessive administrative costs, we believe the resulting benefits would be extremely limited.

(3) Some lease contracts have contingent rentals so that the lessor can charge the lessee with lease payments covering the expenses actually incurred by the lessor. If the proposal were to be applied to these contingent rentals, it would result in cases where the lessor's expenses and revenue would not correspond.
The recognition of receivables and liabilities based on estimated values is very likely to invite arbitrary adjustment of amounts based on business performance.

Therefore, as a rule, lease payment amounts should be computed based on minimum lease payments. On that basis, consideration should be given to entities that compute expected outcomes based on management’s judgment. For that purpose, we believe it would be appropriate to allow such entities to opt for the expected outcome technique if they prefer to do so. Alternatively, it would be appropriate to take into account contingent rentals only in cases where a clear disparity exists between a lease contract and the actual situation.

**Question 10: Reassessment**

We support the proposal on the condition that a “detailed examination of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability” as stated in paragraph BC133.

**Question 11: Sale and leaseback**

We generally support this proposal, but request the inclusion of guidance on the following matters in the event that the performance obligation approach is incorporated into the standard (as stated in our response to Question 2, we oppose the adoption of the performance obligation approach). Paragraph 68 states that the performance obligation approach applies if a transfer meets the conditions for a purchase. However, it is conceivable that, when a transfer that meets the conditions for a purchase is made, “significant risks and benefits” are assigned to the transferor/lessee in a leaseback transaction at the same time. We believe this matter requires further guidance. In other words, while paragraph BC166 states that “a combined transaction is accounted for as a sale and leaseback only when the transferee/lessor remains exposed to significant risks and benefits,” paragraph 68(a) specifically stipulates, “if the transfer meets the conditions for a purchase.” (Underlining added.) As such, paragraph 68(a) does not provide for making a judgment based on both the transfer contract and the leaseback contract. As the foregoing situation may theoretically occur, we request that guidance be given on this matter.

**Question 12: Statement of financial position**

We basically support the proposal.

However, as stated in our response to Question 2, we do not support the adoption of the performance obligation approach primarily because of the lack of clarity on the status of net lease assets.
Question 13: Statement of comprehensive income

We basically support the proposal. However, guidelines should be established concerning the form of presentation.

Question 14: Statement of cash flows

We basically support the proposal. However, we believe that in certain cases, cash payments made by lessees should be classified as investing activities.

Question 15: Disclosure

We do not agree with the following points.

- We oppose the disclosure requirement of paragraph 73(b) whereby entities are required to disclose "information about the principal terms of any lease that has not yet commenced."

- Preparation of reconciliation (paragraphs 77 and 80) should be limited to right-of-use assets and performance obligations for the following reasons. First, financial assets and liabilities are not subjected to the disclosure requirement the ED imposes on lease receivables and payables, and there is very little necessity for such disclosure. Second, quantitative information on residual assets has very little importance.

Question 16: Transition

(a) We basically support the proposal. For the following reasons, we believe it is appropriate to adopt a simplified retrospective approach as mentioned in ED as the single method for recognition and measurement. Firstly, for many entities, full retrospective application of the proposed standard will be very difficult from a practical perspective. Second, if some entities were to opt for full retrospective application, this would undermine the comparability of financial information.

However, even the simplified retrospective approach would be excessively burdensome for entities entering into very large numbers of small-amount lease transactions. For such cases, we propose that consideration be given to establishing a cutoff date marking the start of the retrospective period.

Paragraph 90 stipulates that the lessee's incremental borrowing rate shall be used in transitional lessee accounting. However, provisions should be made to allow the use of the rate the lessor charges the lessee where it is known. Our reasoning is as follows. When a lessor is providing a lessee with comprehensive services pertaining to lease transactions, the lessee will require support in making the transition (for journal entries, etc.). In this case, although the rate the lessor
charges the lessee is known, the designation of the lessee's incremental borrowing rate as the only rate that can be used will create an additional administrative burden to investigate the lessee’s incremental borrowing rate separately for each counterparty.

(b) Full retrospective application should not be permitted (see (a) above).

Question 17: Benefits and costs

While we appreciate that benefits outweigh the costs for all lease transactions taken as a whole, we are in agreement with the statement made in paragraph BC203. That is, cost-benefit performance is particularly low where entities hold large numbers of small-amount leases (store and office equipment and fixtures, etc.). Simplified measures should be adopted for application to such cases (see our response to Question 1).

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