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Japan Property Management Association

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International Accounting Standards Board 30 Cannon Street London EC4M 6XH

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Comments on the Exposure Draft Leases

To the Board Members:

Japan Property Management Association ("we" and "our") very much appreciates the continued efforts of the International Accounting Standards Board ("IASB") and the Financial Accounting Standards Board ("FASB") on this project to improve accounting for leases. We also thank the Boards for the opportunity to comment on the exposure draft (ED), Leases ("ED") proposed by

the IASB.

We are the industry association, composed of 79 members of the sublessors of residential rental properties (hereinafter referred to as "sublessors" collectively). The number of units sublet by the member companies totals approximately 1.3 million units which represent approximately 10% of the residential rental units totaling approximately 13 million throughout Japan. Our member companies include the consolidated subsidiaries of the listed Japanese companies expanding its business overseas. These companies may be directly affected by the proposals in the ED if their Japanese parent companies decide to apply the IFRS voluntarily or the listed companies are mandatorily required to apply the IFRS in the future in Japan. In addition, other member companies may be significantly affected if the proposals in the ED are incorporated into the lease accounting under the Japanese GAAP along with the convergence of the accounting standards.

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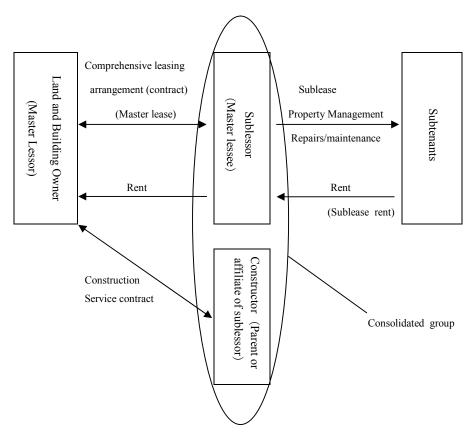
To this end, we have reviewed the proposals in the ED from the perspective of the sublessor engaged in the residential rental business. Firstly, the overview and characteristics of the business of sublessors generally referred to as the "comprehensive leasing arrangement" are described in this letter so that the business model of the sublessors in Japan could be clearly understood. Secondly, we have addressed the potential impacts of the ED on the sublessors and provided our comments.

1. Business model of the "comprehensive leasing arrangement" for rented apartments

In Japan, the residential rental property including apartments and condominiums has been popular since the 1990's among the landlords for purposes of utilizing their land effectively and/or saving their inheritance taxes. Essentially, the property rental business involves certain risks of vacancy or rent reduction. In order to meet the owners' needs of mitigating such risks, the sublessors (typically constructors of rented apartments or their affiliates) have developed the business model called the "comprehensive leasing arrangement". In due course, this arrangement has been widely accepted in the market and the number of contracts has shown the stable growth up to the present.

The "comprehensive leasing arrangement" is a contract where the sublessor leases the entire property from its owner (i.e. landlord) and provides comprehensive property and lease management services. In turn, the sublessor sublets the subject property to subtenants. As a specific characteristic, services including tenant recruitment, collection of rent from subtenants, property management are totally provided by the sublessor, and the fixed amount of the rent (approx. 80-90% of the rent of subleases) is paid to the owner regardless of occupancy. Recently, in most contracts, the rent payable to the owner is initially fixed for certain period and subsequently revised every two to five year based on the rental market condition, etc. In addition, the number of the "comprehensive leasing arrangement" which contains the term that the costs for restoration at the end of tenancy and long-term repairs/maintenance are borne by the sublessors is increasing.

From a legal perspective, the "comprehensive leasing arrangement" is the combination of the master lease agreement with the owner (master lessor) and the sublease agreement(s) with the subtenant(s). The sublessor earns the consideration (i.e. net rental income deducting the rent payable to master lessor) by providing comprehensive services on behalf of a master lessor, including designing and construction of rental properties, tenant recruitment, maintenance of the property, collection of rents, actions to address risk of vacancy and rent reduction, restoration at the end of tenancy and long-term repairs/maintenance.



[Business model of "comprehensive leasing arrangement"]

2. Our comments on the ED

(1) Our comments to the ED "Q1: Identification of leases"

i) Our comments

We agree with the definition of a lease in paragraph 6. However, we do not agree with the proposed requirements set out in paragraph 7-19 for an entity to determine whether a contract contains a lease. This is because certain service contracts including "comprehensive lease arrangement" would be determined to be a lease in accordance with the proposed requirements. In determining whether a contract contains a lease, we believe that an assessment from a business model perspective should be also included. It should be clearly stated that if a lessor has an option to terminate the contract, such contract is not determined to be a lease given that the right to control the use of the identified asset is not conveyed.

ii) Rationale of our comments

In the ED, a lease is defined as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". If a contract is

determined to a lease, the lessee is required to account for a lease based on a right-of-use model (the lessee recognizes a right-of-use asset and a lease liability). There are the requirements in paragraphs 7-19 of the ED under which an entity determines whether a contract is or contains a lease. We believe that the requirements in paragraphs 7-19 would be effective in determining that a contract is a lease where a contract does not take the legal form of a lease, but a contact is in substance a lease. However, we consider that those requirements are not sufficient in determining that a contract is not a lease where a contract takes the legal form of lease, but a contract is in substance a service contract. For example, a "comprehensive leasing arrangement" is in substance different kind of agent services for the apartments rental business performed on behalf of its owner while a contract takes the legal form of a lease. Notwithstanding, such contract will be determined to be a lease in accordance with the requirements proposed in the ED and the accounting under right-of-use model is applied, which may lead to the financial reporting that would not represent the company's business model appropriately. In order to address these issues, we believe that the assessment from a business model perspective should be included in the requirements in paragraphs 7-19 which set out the approaches for an entity to determine whether a contract contains a lease.

In addition, the "comprehensive leasing arrangement" contains certain contracts that may be terminated by a lessor at any time with several months' prior notice. If a lessor has the right to terminate a contract, a lessee does not control the use of the underlying asset, and such contract does not fall under the category of lease. In accordance with the paragraph 8 of the ED, if a supplier has the substantive right to substitute the asset, fulfillment of a contract does not depend on the use of an identified asset. Therefore, such contract is not determined to be a lease. The lessor's right to terminate a contract would be stronger compared to a substantive right to substitute the asset in terms of a control of asset by a lessor. Consequently, it is reasonably justified that a contact is not determined to be a lease if a lessor has the right to terminate a contract in comparison with the paragraph 8.

(2) Our comments on the ED "Question 4: Classification of leases"

i) Our comments

We agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied to different classification criteria, depending on whether the underlying asset is property based on the requirements set out in paragraphs 28-34. This is because the nature of property is different from those of assets other than property. We also agree that the property leases are assumed as Type B leases. Notwithstanding, we do not agree that the provision in paragraph 30: if either criterion below is met, the lease is classified as a Type A lease: ((a) the lease term is for the major part of the remaining economic life of the underlying asset or (b) the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date. This is because even if either of (a) or (b) is met, there are certain leases that the lessee is not expected to consume more than an insignificant portion of economic benefit embedded in the underlying asset in terms of other characteristics, and such lease should be classified as a Type B lease.

Accordingly, we believe that "other characteristics" should be included in the classification criteria for property leases. The example of "other characteristics" includes the following:

- 1) if the lease payments for major part of non-cancellable period are variable lease payments (unless otherwise applied to (b)(c) in paragraph 39) or;
- 2) if a lessor has an option to terminate a contract.

ii) Rationale of our comments

If the "comprehensive leasing arrangement" is determined to be a lease <u>despite our comments</u> stated in (1)"Question 1: Identifying a lease" above, we assume that such lease is determined to be a Type B lease as it is a property lease. Notwithstanding such contract would be classified as a Type A lease if one of the following two criteria is met:

- (a) the lease term is for the major part of the remaining economic life of the underlying asset: or
- (b) the present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

In the ED, the lease term is defined as the "non-cancellable period of the lease when the lessee has right of use of an asset" together with both of "periods covered by an option to extend the lease (if the lessee has a significant economic incentive to exercise that option)" and "periods covered by an option to terminate the lease (if the lessee has a

significant economic incentive not to exercise that option)". In order to maximize the revenue from the business and achieve the appropriate profit sharing between the contracting parties, a contract has been fulfilled by consenting the level of rent and the repairs and maintenance costs projected between the owner (master lessor) and the sublessor (master lessee). However, a contract may be terminated earlier during the contract period if it is not considered possible to continue a contract since consensus may not be reached between the parties. As such, it would be appropriate to consider that the lease term is the protected period of the fixed lease payments. If a lessee does not have an option to terminate a contract unilaterally or a lessee has a significant economic incentive not to exercise an option to terminate even if a lessee has the option, the entire term of the "comprehensive leasing arrangement" may be possibly determined to be a non-cancellable period of a lease. If this lease term is determined to be a major part of the remaining economic life of the underlying asset(*), the "comprehensive leasing arrangement" is classified as a Type A lease.

(*) As the criteria to determine the term "major" is not defined, we note that it is highly likely that there may be confusion arising from discrepancy in views between the entity and its accounting auditor.

If a lease is classified as a Type A lease, such lease should be accounted for in the same as finance lease in accordance with IAS 17 *Leases*. In addition, the construction revenue of the affiliate which constructed and sold the property to the owner may not be possibly recognized in accordance with the provisions of sale and leaseback transactions (paragraphs 110-115 of the ED). If such accounting is applied, the financial performance of sublessors may be significantly deteriorated, and it would not be possible to continue business unless otherwise its business model is modified.

In BC 337 of the ED, it is stated that only a lessee's statement of financial position would generally be expected to change for leases of property classified as operating leases according to IAS 17 *Leases*. It is assumed based on this description that the operating leases under IAS 17 would be classified as Type B leases and the finance leases would be classified as Type A leases, in classifying property leases. According to IAS 17, the criteria of (a) and (b) specified in the provision in paragraph 30 in the ED have been included in the criteria in determining whether a lease is a finance lease. However, these criteria are not "determinative" and a contract may be classified as operating lease based on "other characteristics" in certain cases.

The proposal in the ED poses a serious problem in that any property leases need to be classified as Type A leases if either of these two requirements is met without regard to

"other characteristics". We believe that the classification of property leases should be determined in further considering the "other characteristics" in the same way that IAS 17 is applied (for example, if the lease payments for major part of non-cancellable period are variable lease payments or if a lessor has an option to terminate a contract).

In conclusion, we strongly recommend that the Boards take into account these issues thoroughly before it is issued as the final standard and then make necessary revisions to the issues in the ED as addressed above.

(End of text)