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15 December 2010

Dear Sir/Madam

EXPOSURE DRAFT – LEASES

Japan Chain Stores Association

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The Japan Chain Store Association (“the Association”) consists of chain store operations engaged in retail business operations. We respect the efforts made by the International Accounting Standards Boards (IASB) and the Financial Accounting Standards Boards (FASB) to improve lease accounting. We recognize that the primary purpose of the Exposure Draft *Leases* (“the ED”) is to pursue a single approach for the lease accounting based on the right-of-use model of underlying assets regardless of the type of lease arrangements utilized, in order to make it possible to consider, based on a single rule, lease arrangements that were previously treated as off-balance sheet financing.

We have a number of significant concerns, however, with the accounting treatment specified in the ED in terms of the estimation factors that may be relied on for establishing information on an entity’s leasing activities. In the retail store industry such as the chain store business, lease arrangements are numerous both for lessees and lessors due to multi-store management and lease terms tend to be lengthy since the

lease arrangements involve real estate.

We therefore provide our comments below on both determining lease terms and accounting for contingent rentals as it is necessary for our business to have practical solutions in place for estimating these items.

Specific Questions:

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?

- ▶ The Association (a member company of the Association is defined as a retail business whose business model is management and operations of more than eleven stores under the same capital ownership) supports the boards' assessment that, as indicated in the ED, the lease term should reflect an entity's reasonable estimation and, in determining the lease term, an entity (lessee and lessor) should consider all relevant factors including contractual and non-contractual factors, business factors and other lessee-specific factors such as lessee's intentions and past practice.
- ▶ The Association does not agree with the boards, however, in that a lessee and 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. The following are our arguments for disagreement with the boards.
- ▶ Given that this industry is characterized by frequent store investment renewals due to the nature of its highly competitive environment, it is extremely difficult to reasonably measure the probability of lease arrangement renewals (i.e., whether or not the option will be exercised to extend the lease term) for each store.
- ▶ Since the chain store industry is inherently characterized by "multi-store development and various types of diversified lease arrangements," considerable cost and time is required to estimate the renewal frequency probability for each store. Furthermore, there would be a significant number of individual stores to be considered.

- ▶ Within the chain store industry, there is a high probability that lease terms are generally spread out over a long period of time and the probability of store closures is also dispersed over the long term. Thus, a significant gap can arguably be anticipated between the actual lease term and the longest estimated possible lease term that is more likely than not to occur at initial recognition.
- ▶ Use of the more applicable threshold higher than the “reasonably assured” threshold could result in less frequent reassessments of liabilities as indicated in paragraph BC 119 of the ED. For the chain store industry in particular, reducing the frequency of lease liability reassessments decreases associated costs and time burdens and enhances the usefulness of financial reporting.
- ▶ Initial recognition of a lease liability based on an estimation of the lease term with the longest possible term that is more likely than not to occur does not reliably reflect future cash out-flows of lease payments. Such a recognized liability would not properly capture the reasonable probability of the liability occurring in actuality. This situation would be inconsistent with a definition of liability in the Board’s Conceptual Framework.
- ▶ In addition, interest expense amounts would be exceptionally high early in the lease term because the subsequent measurement requires a lessee to measure the lease payment liability at amortized cost using the effective interest method. Therefore, this lease liability possibly having been estimated unreliably as noted above would adversely promote such a front-end interest expense burden and this would lead to irrational results inconsistent with the steady cash-outflows arising from lease arrangements and balanced income and expense that are associated with lease arrangements.
- ▶ Furthermore, we have concerns that an initial recognition of the right-of-use asset based on a lease liability with a less reasonably known probability of occurring, and subsequent depreciation and impairment of such assets would result in depreciation expenses and impairment losses that would not reflect the true economic substance of the lease transactions.
- ▶ Given these arguments above, the Association believes that the longest possible lease term that is “more likely than not” to occur does not show a reasonable probability of occurring as a liability for the lessee and the lessor and, therefore, it is necessary to use the more

applicable threshold higher than a “reasonably assured” threshold to occur to reliably estimate future lease term.

- ▶ Furthermore, a lessor should not consider contingent factors of the lease term such as an option to extend the lease term and an option to terminate the lease arrangement unless they can be measured reliably, as described in the ED for estimation of contingent rentals. It is necessary for lessors to apply the non-cancellable term as the lease term because it is generally difficult for lessors to measure reliably a contingent lease term that depends on the actions of lessees.

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?

- ▶ The Association supports the boards’ proposed assessment that contingent rentals should be included in the measurement of lease liabilities for lessees and lessors. As described in paragraph BC125 of the ED, where a lease could specify zero fixed lease payments and high contingent rentals, the right-of-use asset and right to receive lease payments for such a lease would be zero if contingent rentals were not included in the measurement of those rights. This would reduce comparability and undermine economic substance.
- ▶ We support the boards’ decision that the lessor’s right to receive lease payments should reflect contingent rentals and amounts receivable under residual value guarantees only if they can be measured reliably. As described in paragraph BC 126 of the ED, it may be difficult for lessors to estimate contingent rentals that depend on the actions of lessees.

- ▶ Based on the following reasons, however, the Association disagrees with the boards' assessment that contingent rentals that are specified in a lease arrangement should be included in the measurement of assets and liabilities that arise from a lease arrangement using an expected outcome technique for lessees and lessors.
- ▶ The Association is characterized by three factors: (1) multi-store development where there are a considerable number of stores subject to lease arrangements; (2) since leased assets are retail stores (real estate) in this industry, lease terms are inherently over long periods of time; and (3) contingent rentals are determined based on a specified percentage of a store's sales performance that is generated from the underlying asset.
- ▶ As indicated in paragraph BC128 of the ED, an expected outcome technique needs not always consider all possible outcomes using complex models and techniques and it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows.
- ▶ Given the three characteristics of the chain store industry noted above, estimations of probabilities under scenarios that have a limited number of sales contingent factors for a long-term lease term at every store would lead to extreme uncertainty and require a considerable amount of time and effort compared to other industries. The chain store industry therefore disagrees with the boards' assessment that contingent rentals should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique. The Association proposes the following alternative approach for lessees and lessors.
- ▶ The Association proposes that lessees and lessors use a measurement approach based on the most likely lease payments instead of an expected outcome technique.
- ▶ The most likely lease payments for the chain store industry in terms of contingent rental estimations would be considered based on a sales budget for each store at initial measurement. Although paragraph BC129 of the ED states that such an approach would place too much emphasis on a single outcome, even if this single outcome turns out to be erroneous in the future, a subsequent reassessment of contingent rentals would revise such an error and significant factors for contingent rentals would be appropriately incorporated in the adjusted estimate.