Japan Leasing Association
Secom-Sonpo Bldg., 2-6-2, Hirakawa-cho, Chiyoda-ku, Tokyo 102-0093
JAPAN Tel. +81(3)3234-1501 Fax. +81(3)3234-5330 【http://www.leasing. or. jp】

February 19, 2010

Sir David Tweedie
Chairman
International Accounting Standards Board

Dear Sir David,

The Japan Leasing Association (JLA) has submitted comments regarding its request for the publication of a Discussion Paper on lessor accounting, as per the comment letter dated January 28, 2010.

Attached hereto is JLA's comment letter regarding its views (proposals) on lessee and lessor accounting.

The proposals by JLA do not deny the outcome of deliberations by the boards. Instead, they seek to resolve the issues surrounding the off-balance accounting for operating leases pointed out in theoretical accounting and the current lease accounting standard while respecting the deliberations.

Combined with the previous comment letter, we strongly hope that the boards will consider our comments in a constructive manner.

Yours faithfully,

Takao Sunami
Chairman, Japan Leasing Association

JLA Comments on the Project on Lease Accounting (Proposals for Lessee and Lessor Accounting)

1. Outline of the Comments

— It is difficult to apply a single accounting model to all leases.

1.1 The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (hereinafter collectively referred to as "the boards") have determined that a single accounting model be applied to all leases, and tentatively decided to adopt the "right-of-use model" for lessee accounting and the "performance obligation approach" for lessor accounting.

1.2 However, the JLA believes that it would be theoretically inappropriate and practically difficult to apply a single accounting model to all leases. Given that the boards have tentatively decided to exclude leases that are in substance the same as purchases or sales of underlying assets from the scope of the new lease accounting standard, new problems would arise from applying a single accounting model to lease transactions that vary widely in form.

1.3 Therefore, the JLA proposes that any new lease accounting standard should reflect the economic substance of various leases and take costs/benefits into consideration, as described below.

2. JLA's Basic Views on Lease Accounting

(1) Application of right-of-use model (for lessee) and application of derecognition approach (for lessor)

2.1 The JLA believes that the derecognition approach for a lessor would be acceptable and applicable to leases in which the right-of-use model is applied to the lessee. In a nutshell, the right-of-use model is based on the view that the lessor's performance obligation is fulfilled upon the delivery of the leased item and the lessee has an unconditional obligation to pay rentals. The derecognition approach is based on the view that the lessor's right to receive rental payments is unconditional and is generated in exchange for the lessee's right of use. Consistency between lessee accounting and lessor accounting is deemed to be ensured by applying the derecognition approach to the lessor.

2.2 In lease transactions classified as finance leases under the current standard, the lessor has no obligation to continually permit the use of the leased item over the lease term as assumed under the performance obligation approach. Accordingly, the receivables associated with the right to receive rental payments are not receivables corresponding to the performance obligation. The proposed accounting by the boards (the performance obligation approach) is theoretically inconsistent with the proposed accounting for a lessee.

(2) Existence of leases for which right-of-use model (for lessee) and derecognition approach (for lessor) is inappropriate

2.3 As explained in 2(1) above, the JLA believes that if the right-of-use model is to be applied to the lessee, the derecognition approach would be acceptable for lessor accounting in terms of theoretical consistency, but it would be inappropriate to apply this combination to all leases.

2.4 The JLA believes that for the leases referred to in (a) through (d) below, a combination other than the right-of-use model and the derecognition approach would be appropriate. Such leases are deemed distinguishable from leases to which the right-of-use model and the derecognition approach are applied.

[A] Leases to which the operating lease approach would be appropriate (for lessee and lessor)

(a) Leases cancelable at any time (including leases requiring no payment of cancellation charge even if there is a non-cancelable period)

(b) Lease of an asset intended to be leased to an unspecified number of entities or persons (e.g. automobile lease)

(c) Lease of real estate and other similar property

[B] Leases to which either the operating lease approach or simplified accounting based on right-of-use model (for lessee) and the performance obligation approach based on net presentation (for lessor) would be appropriate

(d) Leases with strong service characteristics (excluding (a) through (c) above)

3. Accounting for leases to which right-of-use model (for lessee) and derecognition approach (for lessor) would be inappropriate

(1) Application of operating lease approach to leases cancelable at any time, etc. (for lessee and lessor)

3.1 The boards have proposed the right-of-use model on the grounds that the lessee's right to use the leased item meets the definition of an asset and the obligation to pay rentals meets the definition of a liability. However, the right of use does not necessarily meet the definition of an asset with respect to all leases, and by the same token, the obligation to pay rentals does not necessarily meet the definition of a liability for all leases.

3.2 For example, in the case of "(a) leases cancelable at any time" (including leases requiring no payment of cancellation charge even if there is a non-cancelable period), neither the right of use nor the obligation to pay rentals is fixed over the entire contractual lease term. It is highly doubtful that the right of use including such uncertainty meets the definition of an asset and the obligation to pay rentals including such uncertainty meets the definition of a liability.

3.3 In addition, "(b) lease of an asset intended to be leased to an unspecified number of entities or persons" (e.g. automobile lease) and "(c) lease of real estate and other similar property" held to earn rentals or for capital appreciation or both by leasing it to an unspecified number of entities or persons require the lessor to maintain and manage the asset for the entirety of its economic life in some cases. Lessors in those leases are exposed to risks associated with maintaining and managing the item and inventory risks, rather than credit risks with respect to the lessee.

3.4 Therefore, in regards to "(a) leases cancelable at any time" (including leases requiring no payment of cancellation charge even if there is a non-cancelable period), for which the recognition of assets and liabilities on the lessee side would be inappropriate, and "(b) lease of an asset intended to be leased to an unspecified number of entities or persons" (e.g. automobile lease) and "(c) lease of real estate and other similar property", for which the economic substance could be presented by the depreciation of assets and the recognition of the rental income in profit and loss on the lessor side, the accounting treatment currently applied to operating leases is deemed to be best suited for both the lessee and lessor, in consideration of the consistency with the accounting treatment of executory contracts other than lease contracts.

3.5 For these reasons, the JLA believes that the accounting treatment currently applied to operating leases should be preserved under the new standard.

(2) Either operating lease approach or simplified accounting based on right-of-use model (for lessee) and performance obligation approach based on net presentation (for lessor) to leases with strong service characteristics

3.6 Among lease contracts, there are leases in which the lessor maintains and repairs the leased item or otherwise provides services associated with the use of the item. The aforementioned lease of assets intended to be leased to an unspecified number of entities or persons and the lease of real estate and other similar property are typical examples of such leases. Another example is the lease of automobiles which often involves troublesome management and services such as inspection/maintenance of the leased item (automobile), repairs, handling of accidents, and replacement of oil, tires and other consumables.

3.7 The boards are scheduled to discuss the treatment of leases including services in a future meeting. Given that the nature of services included in lease contracts varies widely and the lessor establishes rentals covering the services as a whole rather than calculating rentals with respect to each individual service, it would be virtually impossible for the lessee in actual practice to recognize rentals by distinguishing between the rentals pertaining to the usage portion and the rentals pertaining to the service portion of the leased item. Accordingly, for leases including services, the lease and services should be treated as one in accounting, instead of recognizing the rentals by distinguishing the services from the lease. This is also deemed preferable in view of costs/benefits.

3.8 Therefore, for 2.4 “(d) leases with strong service characteristics”, it is deemed acceptable for a lessee to recognize rentals as expenses on the payment date and appropriate to apply the operating lease approach, given that the total amount of the rentals over the lease term includes the amount pertaining to the executory portion from the lessee’s point of view, and that it is virtually impossible for the lessee in actual practice to recognize the rentals by distinguishing between the rentals pertaining to the usage portion and the rentals pertaining to the service portion of the leased item.

3.9 In the case of the operating lease approach, however, a problem has been pointed out: the right-of-use assets and the obligation to pay rentals (pertaining to the determined portion) are not recognized on the lessee side. As this does not help resolve the issues surrounding the off-balance accounting for operating leases, one possible solution is to apply the simplified accounting method based on the right-of-use model in place of the operating lease approach.

3.10 Even if the right-of-use model is to be applied to the lessee, it is deemed acceptable to allow a lessee to choose a simplified accounting method based on the right-of-use model for leases with strong service characteristics. In the simplified accounting method proposed by JLA, a lessee would initially recognize the right-of-use assets and the obligation to pay rentals at the sum of the lease payments payable, and the lessee would depreciate the right-of-use assets based on the amount of the lease payments payable. Similarly, the lessee would decrease the obligation to pay rentals by the amount commensurate with the satisfaction of the obligation to pay rentals (that is the amount of lease payments payable.). In consideration of the factors with service characteristics, it would be appropriate to apply the simplified accounting method by JLA instead of the proposed accounting treatment with strong financial characteristics.

3.11 From the lessor’s viewpoint for leases with strong service characteristics, the performance obligation approach is deemed appropriate, given that the portion pertaining to the obligation to be performed by the lessor over the lease term is included. In this case, the receivables and the performance obligation should be presented in net amount, as suggested in the comment letter dated January 28, 2010.

3.12 Furthermore, if the right-of-use model is to be applied to the lessee as described in 3.10, it is deemed acceptable to recognize expenses on a straight-line basis. Therefore, by the same token, if the performance obligation approach is to be applied to the lessor, JLA proposes that a lessor recognize its revenue on a straight-line basis (which involves recognizing receivables and obligations at the sum of rentals, presenting the amount in net terms, reducing receivables by the amount of rentals received, reducing obligations by the amount of rentals received and recognizing the rental received as revenue).

4. JLA's Views on Other Important Issues

(1) Recognition of lease term of lease that includes options

4.1 As explained in 3.2 above, the JLA highly doubts that the right of use arising from leases cancelable at any time meets the definition of an asset and the obligation to pay rentals meets the definition of a liability. The JLA has the same view on assets and liabilities in leases that include options. In other words, uncertainties should not be taken into consideration when measuring leases that include options; the initially recognized lease term should be limited to the contractual non-cancelable lease term.

4.2 JLA understands that the boards have tentatively decided to adopt "the longest possible lease term more likely than not to occur", in order to eliminate the cases where short-term leases are intentionally arranged and options are repeatedly exercised for the purpose of understating assets and liabilities (in such cases, leases of the same nature as finance leases are consequently accounted for as operating leases under the current standard).

4.3 However, it is impossible in actual practice to apply the option accounting proposed by the boards to all leases, and for the majority of leases other than intentionally-arranged leases, there is no motive to put together short-term leases. Even if there is an option to extend the lease, there should be no problem in performing accounting in the optional period again when the option is exercised after the contractual lease term is recognized.

4.4 Therefore, if a lease with options, in which a specific lessee is likely to use the asset for a long period, is arranged intentionally (lease of assets that are not deemed to obtain revenue from an unspecified number of lessees), the proposed "longest possible term that is more likely than not to occur" should be applied. It is deemed possible to objectively determine whether a lease with options is arranged intentionally or not based on the factors to be considered when deciding the lease term as proposed by the boards (contractual and non-contractual financial factors, business factors, and factors unique to the lessee).

(2) Scope of leases that are in substance the same as purchases or sales of underlying assets to be excluded from new lease accounting standard

4.5 The boards have tentatively decided to exclude leases that are in substance the same as purchases or sales of underlying assets (hereinafter referred to as "leases that are in substance purchases/sales") from the scope of the new standard. As one of the reasons for this, it is difficult to apply the performance obligation approach to leases that are in substance purchases/sales.

4.6 From the viewpoint of lessee accounting, it is simply doubtful for the right of use model to be applied to leases that are in substance purchases/sales when comparing to other purchased asset. From the viewpoint of the lessor, if the lease does not transfer the title of the leased item to the lessee, the leased item will always be returned to the lessor, and the lessor will collect the residual value by selling or leasing the asset to a third party after the lease term. If the returned item is unlikely to be sold or leased, the lessor will have the responsibility to properly dispose of the item in accordance with environmental-protection-related laws and regulations. Hence, the lessor's control over the item is not transferred to the lessee. In contrast, if the lease is in substance a purchase/sale that transfers the title to the lessee, there is no possibility of the leased item being returned to the lessor, so the residual value is not taken into consideration when calculating the lease rentals, and the leased item will be managed and disposed of on the lessee side in a similar manner to items owned by the lessee. Accordingly, the control over such item is transferred to the lessee.

4.7 Therefore, even if the boards adopt the derecognition approach for lessor accounting, leases that are in substance purchases/sales, because they are different from leases that do not transfer the title, should be excluded from the scope of the new standard. The criteria for determining whether a lease is in substance a purchase/sale or not (That is the criteria for determining whether the control over the underlying assets transfers to a lessee or not.) should be limited to "contracts which automatically transfer the title of the underlying asset at the end of the lease" and "contracts that include a bargain purchase option".

(3) Accounting for lease without materiality

4.8 The boards have tentatively decided to apply simplified accounting to short-term leases (leases in which the lease term is less than 12 months) instead of excluding them from the scope, and not to exclude non-core assets from the scope. However, as already repeatedly argued, the JLA believes that leases with a lease term equal to or less than 1 year and leases of non-core assets (assets that are without materiality in light of the business operations of the lessee) are immaterial, and for this reason, the lessee should apply the accounting treatment currently applied to operating leases in view of the costs/benefits.

4.9 For the lessor, it is deemed appropriate to apply an accounting treatment that is symmetrical with that for the lessee. However, whether or not the leased asset is a non-core asset does not directly relate to the lessor, so it is deemed acceptable for a lessor to apply the derecognition approach for leases of non-core assets other than those referred to in (a) through (d) in 2.4 above.

4.10 Even if the leased asset is a core asset, in cases where the ratio of the leased assets to the total property, plant and equipment and intangible fixed assets of the lessee is small, it should be permissible for the lessee to choose the simplified accounting method in which a lessee initially recognizes the right-of-use assets and the obligation to pay rentals at the sum of the lease payments payable, and the lessee depreciates the right-of-use assets based on the amount of the lease payments payable. Similarly, the lessee decreases the obligation to pay rentals by the amount commensurate with the satisfaction of the obligation to pay rentals (the amount of the lease payments payable) in view of the costs/benefits, as described in 3.10.

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