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Sir David Tweedie
Chairman
International Accounting Standards Board

Dear Sir Tweedie:

The Japan Leasing Association (JLA) is extremely interested in and concerned about the developments in the project on lease accounting undertaken by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (hereinafter collectively referred to as the "boards").

The boards currently intend to issue an Exposure Draft on lease accounting encompassing both lessee and lessor accounting in the second quarter of 2010 after considering various issues on lease accounting based on the comments received from constituents in response to the Discussion Paper, *Leases: Preliminary Views* (hereinafter referred to as the "Lessee DP").

However, the JLA has strong concerns about the boards' proceeding to the issuance of an Exposure Draft without publication of a Discussion Paper on lessor accounting and believes that the boards should follow a due process including preparation and publication of a Discussion Paper on lessor accounting before proceeding to the issuance of an Exposure Draft. It is the belief of the JLA that constituents all over the world would agree on this point.

Furthermore, although the JLA submitted comments on the Lessee DP to the IASB, the review status on the comments received by the IASB including ours is not necessarily transparent from the deliberation process by the boards so far.

For these reasons, the JLA decided to submit comments on the project on lease accounting as detailed in the attached document, although we acknowledge that the JLA is not currently given a formal opportunity to make comments on the project undertaken by the boards.

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

1. Due process

1.1 Nearly all of the comments on the Discussion Paper, *Leases: Preliminary Views* (hereinafter referred to as the “Lessee DP”) published by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (hereinafter collectively referred to as the “boards”) were against postponing the consideration of lessor accounting and argued that lease accounting should be examined simultaneously from both the perspectives of the lessor and the lessee. They also strongly urged the boards to publish a separate Discussion Paper on lessor accounting (hereinafter referred to as the “Lessor DP”) before the issuance of an Exposure Draft (IASB/FASB meetings in September 2009: IASB Agenda Reference 6A, para. 13 and 16).

1.2 The JLA contended that in setting a new accounting standard on lease accounting, both lessee accounting and lessor accounting should be included. Therefore, the boards should first issue a Lessor DP to follow the Lessee DP and subsequently, based on the comments received for both discussion papers, the boards should issue a new Discussion Paper including both lessee accounting and lessor accounting before issuing an Exposure Draft, which is to be followed by the issuance of the final accounting standard (JLA Comments on Lessee DP, 6.1 and 29).

1.3 Meanwhile, milestone targets on the lease project (timing of issuance of Exposure Draft and the final standard for lease accounting by the lessee and the lessor) were indicated in “Appendix A Pathway to Completion of MoU Projects” of *FASB and IASB Reaffirm Commitment to Memorandum of Understanding - A Joint Statement of the FASB and IASB*, November 5, 2009.

1.4 The Lessee DP, reflecting the boards’ priority on the development of the lessee accounting model, only introduced two approaches to lessor accounting without providing detailed discussion on the lessor accounting model. As the description of lessor accounting provided in Chapter 10 of the Lessee DP is insufficient for the JLA to make any comments on the question concerning lessor accounting, the JLA refrained from making any comments on lessor accounting at that stage (JLA Comments on Lessee DP, 28).

1.5 Subsequently, the boards tentatively decided to adopt a “performance obligation approach” after considering the lessor accounting model. However, this approach is not only entirely different from the currently practiced lessor accounting, but also has a number of problems in terms of consistency with lessee accounting and the uniform application of such accounting to all leases (refer to the “2. Lessor Accounting” section below).

1.6 For the development of a lessor accounting model, the JLA naturally expected that a Lessor DP would be published before the issuance of an Exposure Draft. If an Exposure Draft encompassing both lessee and lessor accounting were to be issued directly without publishing a

Lessor DP, such standard setting process would not be considered appropriate. From the perspective of developing a new lease accounting standard to be applied by most of the world replacing the current lease accounting standard, the JLA strongly urges the boards to follow a due process including preparation and publication of a Lessor DP for public comments, and after making careful and sufficient consideration based on the comments, to publish another Discussion Paper which ensures the consistency between lessee accounting and lessor accounting before issuing an Exposure Draft.

2. Lessor Accounting

2.1 Problems of the Performance Obligation Approach

The boards tentatively decided to adopt a “performance obligation approach” to lessor accounting. However, this approach has the following problems.

(a) Problem associated with the creation of a new obligation

One of the rationales for adopting a lessee right-of-use model (which requires recognition of a right-of-use asset and a liability for obligation to pay rentals) is the understanding that the lessor’s obligation has been performed upon the delivery of the leased item. This is also apparent from the conclusion of the Lessee DP that the lessee has an unconditional obligation to pay rentals (which denies an argument that unless the lessor provides the lessee with the leased item and permits its use, the lessee has no obligation to pay rentals) (the Lessee DP, para. 3.18 and 3.19).

Furthermore, in the description of the derecognition approach, it is also stated that the lessor is not considered to have a liability to permit the lessee to use the leased asset (IASB/FASB meetings in May 2009: IASB Agenda Paper 11, para. 22 and 23).

Although the JLA does not necessarily consider that the lessor’s performance obligation has been fulfilled upon the delivery of the leased item, it notes that inconsistency exists between the explanation of the performance obligation approach that “the lessor is committed to allowing the lessee to use the leased item over the lease term” (para. 32 of the same paper) and the adoption of the lessee right-of-use model on the ground that the lessee has an unconditional obligation to pay rentals. Therefore, the boards should solicit public comments before issuing an Exposure Draft on the inconsistency that nonperformance of obligation under a lease contract is denied for lessee accounting, but is sustained for lessor accounting.

(b) Problem associated with the creation of a new right

It is considered that the lessor’s right to receive rental payments from the lessee, by nature, should not vary depending on the approaches taken (IASB/FASB meetings in May 2009: IASB Agenda Paper 11, para. 14 and 15).

However, the lessor’s right to receive rental payments is regarded as being exchanged for the lessor’s right to use the leased item under the derecognition approach (para. 18 of the same paper), while it is regarded as a new right created with a corresponding liability (an unconditional obligation to permit use of the leased item to the lessee under the performance obligation approach (para. 35 of the same paper).

Such notion of the creation of a new right may be supportable if the lessor's unconditional obligation to permit use of the leased item to the lessee is considered to have a characteristic that it remains over the lease term.

If so, however, as noted in (a) above, the boards should solicit public comments before issuing an Exposure Draft on the appropriateness of the notion that the lessor has an unconditional obligation to permit use of the leased item to the lessee over the lease term and the obligation is performed over the lease term as the rental payments are collected by the lessor.

(c) Problem associated with the recognition of both leased asset and lease receivable

It is stated that under the performance obligation approach the leased item is treated as the lessor's economic resource and the lessor does not lose control of the leased property for the lease term and thus continues to recognize the leased item (IASB/FASB meetings in May 2009: IASB Agenda Paper 11, para. 32).

Although the definition of the "control" mentioned above has not been clearly indicated in the papers on the meetings through November 2009, the staff recommended using a control principle to determine whether a lease contract is in fact a purchase or sale of the underlying asset, i.e., if a contract transfers control of the underlying asset, it is in fact a purchase or sale and should be excluded from the scope of the leases guidance (IASB/FASB meetings in December 2009: IASB Agenda Reference 4D, para. 15).

The boards should explain more clearly the relationship between the abovementioned "control" as used in the context of the lessor's not losing the control of the leased property and the statement that the lessor has an unconditional right to receive rental payments from the lessee, i.e., the relationship between the leased asset and the right to receive rental payments over the lease term as well as the appropriateness of recognizing both of these assets at the same time. Such explanation is also expected to be related to the consideration under the revenue recognition project.

Although the presentation will be considered going forward, given the need to ensure consistency with the revenue recognition project, it is expected that the lease receivable and the associated performance obligation will be required to be presented net.

However, under the current situation in which a tentative decision has not been made on whether the net or gross presentation should be used, for leases such as finance leases under the current standard, for example, the assets will be recorded for an amount far exceeding the inflow of economic benefits and the associated risks (put simply, the amount of the assets will be twice as much).

It is questionable for what purpose such information on the assets is provided to users of financial statements. If both the leased asset and the lease receivable are recognized, financial indicators such as capital ratio and ROA, which are important to investment and other decisions, will be significantly impacted through the increase in the total assets. As a result, the comparability between companies that engage in the leasing business and companies that do not will be lost. Consequently, investors and other users of financial statements will be forced to make adjustments to statements of financial position in order to maintain comparability, which may also cause misunderstanding. Therefore, it is necessary to hear opinions of the constituents on the performance obligation approach also from the presentation perspective as discussed above. For all the lessor constituents including the JLA, the gross presentation is unacceptable.

Furthermore, the intermediate lessor in sublease transactions has a problem of recognizing both the right-of-use asset and the lease receivable, which also requires sufficient consideration.

2.2 **Appropriateness of the approach encompassing the lessee accounting model**

In the comments on the Lessee DP, the JLA argued that requiring the application of the same accounting treatment as applied to finance leases under the current standard to all leases is inappropriate and would lead to new problems; for leases with strong service characteristics, it was appropriate to recognize a right-of-use asset at the sum of the lease payments payable by the lessee over the lease term; and therefore similar to the existing standards, the new standard should provide criteria to make a distinction between leases with strong service characteristics and others and, with respect to the former, permit the lessee to initially recognize a right-of-use asset and a liability for its obligation to pay rentals at the sum of the lease payments (JLA Comments on Lessee DP, 3.1, 3.2, 8, 10, and 11).

To decide on an approach for lessors to apply the right-of-use model, the boards considered the derecognition approach, the operating lease approach, and the dual model approach, in addition to the performance obligation approach (IASB/FASB meetings in October 2009: IASB Agenda Reference 10C).

The boards should clearly explain that the performance obligation approach will be adopted and other approaches will not in a Lessor DP published for public comments before issuing an Exposure Draft.

The problems of the performance obligation approach have already been pointed out in 2.1 above. The JLA also believes that requiring the application of the derecognition approach to all leases is impractical as lessors who enter into a vast number of leases in a wide variety of forms will find it extremely difficult to conform with such requirement in practice.

Given the existence of a wide variety of lease contract forms and in consideration of the actual practice and the cost/benefit on the part of the preparers consisting of both the lessee and the lessor as well as the needs of the users of financial statements, uniform application of a single accounting treatment is not necessarily considered desirable.

From these perspectives, the boards should, in consideration of consistency between lessee accounting and lessor accounting, consider the applicability of different approaches, namely the principle of the right-of-use model, the approach proposed by the JLA, and the operating lease approach for lessee accounting; and the derecognition approach, the performance obligation approach, or the operating lease approach for lessor accounting.

3. Other important issues

3.1 **Accounting for cancelable leases**

In the comments on the Lessee DP, which also relate to the comment under 2.2 above, the JLA argued that the right-of-use model should be applied only to non-cancelable leases and that the accounting treatment that is currently applied to operating leases should be prescribed for leases other than non-cancelable leases (i.e., cancelable lease) (JLA Comments on Lessee DP, 2.2 and 4). Although the Lessee DP does not clearly address whether the right-of-use asset or the obligation to pay rentals in relation to a cancelable lease should meet the definition of an asset or a liability, the JLA believes that the operating lease approach is naturally applicable to cancelable leases.

3.2 **Lease terms initially established at initial recognition**

With respect to the treatment of options, the boards tentatively decided that both the lessee and the lessor should use the longest possible term that is more likely than not to occur as the recognition criteria after considering all the relevant factors (IASB/FASB meetings in November 2009: IASB Agenda Reference 5D, para. 37 and 41; IASB Agenda Reference 5G, 5, para. 28, and 33).

With respect to the treatment of options, sufficient consideration has not been given to whether a liability should be recognized by the lessee and whether an asset should be recognized by the lessor in relation to a lease option, not to mention the problems of practical application.

The JLA argued that uncertain factors such as options should not be considered in the recognition of assets and liabilities and the lessee should initially measure an obligation to pay rentals and a right-of-use asset based on the contractual lease term unless the option is priced to provide a significant incentive to exercise the option (the "bargain purchase option" prescribed by the current standard would be an example of such option) (refer to JLA Comments on Lessee DP, 4.1, 19, and 20).

The appropriateness of a liability for the possibility of rental payments for a cancelable term recognized by the lessee as of the reporting date is also questionable.

The JLA's view on the treatment of options by the lessor is similar. The JLA believes that it is even more impractical for the lessor (who typically enters into a vast number of lease contracts) to estimate the longest possible term that is more likely than not to occur for each contract and to recognize receivables based on such estimates than for the lessee. The JLA also questions the appropriateness of recognizing such assets.

Therefore, lease terms initially established at initial recognition should be limited to the "contractual non-cancelable lease term," which can be used consistently by both the lessee and the lessor.

3.3 Scope exclusion for non-core asset leases

The boards discussed the scope of the application in the meetings held in December. The staff thought that short-term leases should be defined as a lease with an expected term of one reporting period or less and proposed that they should be excluded from the proposed new guidance for lessees, while the staff proposed that leases of non-core assets should be within the scope of the proposed new leases guidance (IASB/FASB meetings in December 2009: IASB Agenda Reference 4F, para. 35, 36, and 48).

The boards did not make a tentative decision on the treatment of short-term leases in the December meeting, but tentatively decided to agree with the staff proposal on leases of non-core assets.

As the cost for the recognition and measurement of rights and obligations arising from short-term leases whose term is equal to or less than one year generally exceeds the corresponding benefit, and the assets under such leases are often insignificant assets to the lessee, the JLA argued that the accounting treatment that is currently applied to operating lease should be applied to the leases whose lease terms are equal to or less than one year (JLA Comments on Lessee DP, 5 and 6).

The JLA also argued that non-core assets are assets that are insignificant to the lessee in view of the business operations of the lessee and that if the lessee determines that a given leased asset is insignificant, the accounting treatment that is currently applied to operating lease should be applied to it (JLA Comments on Lessee DP, 5 and 6).

Although the Lessee DP noted the difficulty in defining non-core assets and the possible reduction of comparability for users of financial statements (Lessee DP, para. 2.17), it did not provide sufficient cost-benefit analysis for the application of new leases guidance. Therefore, the boards should perform such analysis and clearly indicate the result of the analysis in a Discussion Paper encompassing both lessee accounting and lessor accounting and publish it for public comments on the views of the boards before issuing an Exposure Draft.