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International Accounting Standards Board
30 Cannon Street
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Comments on the Exposure Draft, *Lease*

To the Board Members:

The Japanese Institute of Certified Public Accountants ("we" and "our") appreciates the continued efforts of the International Accounting Standard Board (IASB) on the lease project, and welcomes the opportunity to comment on the Exposure Draft (ED), *Lease*.

We agree with the basic concept of the lessee accounting proposed in the ED. However, as there are some concerns over the proposed lessor accounting, we believe that several issues, including the interaction with the proposal in the exposure draft *Revenue from Contracts with Customers* (the ED *Revenue Recognition*), need to be more thoroughly considered before reaching to a hasty conclusion.

The accounting model

Question 1: Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why? (b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Comment:

(a) We agree with the basic concept of the proposed lessee accounting.

By entering into a lease contract, a lessee receives a right (an exclusive right to use the leased asset) and assumes an obligation (an obligation to make the lease payments under the contract). This right and obligation commonly come with all lease contracts, and they are likely to meet the definitions of asset and liability under the Framework. Therefore, we consider that the economic substance of the lessee in the lease contract can be faithfully represented, when recognizing the rights and obligations of the lessee as right-of-use assets and liabilities to make lease payments. This will enable a consistent approach to the accounting for lease contracts and will also ensure comparability. Notwithstanding the above, it is necessary to carefully consider some of the specific measurements, such as the measurement of options and residual value guarantees, as discussed in our response to Questions 7 and 9.

(b) We agree that a lessee should recognize amortization and interest payment.

A right-of-use asset is defined as "an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term." The economic benefits the lessee receives by holding a right-of-use asset are considered to be consumed over the expected lease term or the useful life of the underlying asset. Therefore, we believe that amortizing the right-of-use asset over those periods is consistent with the accounting under the current IAS 38 *Intangible Assets*.

In addition, the liability to make lease payments is a consideration payable for the acquisition of a right-of-use asset and is similar to a financial liability. Therefore, we consider that it is consistent to account for the liability by using the effective interest method.

Question 2: Lessors

(a)	Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?
(b)	Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Comment:

(a) We do not agree with the concept of permitting to apply both the performance obligation approach and derecognition approach.

If we assume the right-of-use model for lessees, application of the derecognition approach will be considered to be consistent for the lessor. However, as noted below, since there are a number of concerns over the lessor accounting, several important issues, including the relationship with the ED *Revenue Recognition*, need to be more thoroughly considered, before reaching to a hasty conclusion.

(1) If the derecognition approach is assumed to be the only approach applied to the lessor accounting, as with the lessee accounting, there may be some inconsistencies relating to the accounting by lessor, when the value of an underlying asset such as land do not decrease with the usage over time. In addition, the derecognition approach requires the lessor to derecognize a portion of the underlying asset and recognize the revenue at the date of the commencement of a lease. However, if the underlying asset is a fixed asset, the components of that asset often function as one, rather than by a portion. Although the derecognition approach requires the revenue to be recognized by separating a portion of the underlying asset and derecognizing it, if this approach is to be applied, it may give the lessor a chance to recognize inappropriate revenue, leading eventually to the possibility of entities arbitrarily selecting which accounting to apply.

(2) We understand that the ED suggests to adopt a "risks and benefits" model to lessor accounting in order to preclude any possibility of entities arbitrarily selecting which accounting to apply and it requires the lessor to apply the derecognition model only when the "risks and benefits" are transferred. However, given that the ED *Revenue Recognition* applies the "transfer of control" model, it is not clear whether or not the lessor accounting is consistent with the proposed revenue recognition standard.

(b) For the reasons described above, we do not agree with the proposed lessor accounting.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less: (a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64). (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46.) Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Comment:

We agree that the simplified approaches should be established for short-term leases.

Definition of a lease

Question 4

(a)	Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
(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?
(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?

Comment:

(a) We agree with the proposed definition of a lease, since it retains the current definition of a lease and includes substantive lease within its scope.

(b) We do not agree with the criteria for distinguishing a lease from a contract that represents a purchase or sale.

As described in our response to Question 2 (a), the lessor accounting needs to be considered further.

On the other hand, with regard to lessees, the consequence caused in accounting will not be significant, when a contract equal to a purchase or sale is accounted for as a transaction that represents a purchase or sale, or when it is accounted for as a lease, although there are some differences in the assets being recognized (owned tangible assets or right-of-use asset) as described in this draft. Therefore, we do not agree to establish additional criteria to distinguish a lease contract from a contract that represents a purchase or sale, as it may allow the entities to be a selective when choosing which approach to apply.

(c) We basically agree with paragraphs B1-B4.

As the accounting guidelines under the IFRIC 4 *Determining whether an Arrangement contains a Lease* have not been applied as an accounting convention under the Japanese GAAP, if the proposed guidance will be the only guidance to be provided, we may see some confusion in practice. Therefore, when applying the standard, it will be useful to include similar examples, as referred to in the examples in IFRIC 4.

Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46). Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Comment:

We basically agree with the proposed scope of the standard.

However, for example, leases of intangible assets that is not a licensing agreement, such as software, (e.g., payroll outsourcing that is considered to include a lease contract under IFRIC 4), is within the scope of the current IAS 17 *Lease*.

If the proposed standard replaces the IAS 17, there will be no standard to be applied to the similar transactions such as above, and as a result, each entity may decide to apply various accounting at their own discretion, undermining comparability across entities. Therefore, we suggest that the IASB clarifies the accounting for the lease of intangible assets before the standard comes into effect.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

(c) a lessee should apply the lease accounting requirements to the combined contract.

(d) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

(e) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Comment:

We agree with the proposal.

We consider that the FASB's view, which does not distinguish the service components from lease components, is not appropriate, since profits for service components that have not been earned at the commencement of the lease will also be collectively recognized.

Any exceptions should not be necessary, as we can reasonably expect the lessors to have detailed information related to their own business, and it will rarely be the case when distinguishing service components from lease components will become difficult for them.

Question 7: Purchase options

> The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).
> Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

Comment:

We are concerned about the following issue.

When renewal options are exercised and in a case when an underlying asset is used over its useful life, purchase options and renewal options may bring similar economic effects. If we follow the proposal, the amounts of liabilities to be recognized over the period from the commencement of the lease to the exercise of the purchase options might differ depending on the types of options, even when the purchase options and renewal options are exercised at the same time and when they have similar economic effects. Therefore, we are concerned that transactions can be arbitrarily structured if the purchase options are accounted differently from the renewal options.

Measurement

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?

Comment:

We do not agree with the approach proposed in the standard. If a lease term is determined as the "longest possible term that is more likely than not to occur," the result of the calculation may not accurately reflect the actual term of a lease. Therefore, we suggest that a higher threshold than that proposed in the proposed standard should be established.

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?

Comment:

We agree with the proposal that expected payments for contingent rentals should be included in the measurement of assets and liabilities arising from a lease. However, we have concerns over the use of an expected outcome technique, for the following reasons.

If the obligation to make lease payments is a financial liability, the predictive value of the probability-weighted average of the lease payments (the expected outcome technique) should be adopted. However, it will not be feasible from the cost-benefit point of view, for example, if collecting information to conduct the probability-weighted average calculation will be required even when there is only one scenario. For the case of only one scenario, the approach based on the lease payments that are most likely to occur should also be permitted, rather than requiring the expected outcome technique to all cases.

We also agree with the proposal that lessors should include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments, only if they can be measured reliably. Although we can presume that a lessor negotiates leases with contingent rental arrangements, with some level of understanding from a lessee about the amount of payments most likely to incur, there may be a case when it is difficult for a lessor to obtain information about the behavioral pattern of the lessee. If we force the lessee to have the same level of estimates that are required to the lessor, the accuracy of the estimate may be compromised and entities may become selective in choosing which accounting to apply. Therefore, we agree to the proposal, since it is reasonable to consider the fact that there is asymmetry of information amongst the lessor and the lessee.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Comment:
We agree to the proposal.
In order to provide relevant information that reflects changes in facts or circumstances, it is useful to remeasure assets and liabilities in each reporting period. Considering the benefits arising from the reassessment and costs to conduct the reassessment in each reporting period, it is reasonable to require remeasuring only when there are indications of significant changes in facts or circumstances.

Sale and leaseback
Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

Comment:
We agree to the proposal. However, the criteria to determine whether the transaction is a purchase or sale (in paragraphs B9 and B10) should be modified to be consistent with the new accounting standard on revenue recognition.

We also suggest that some specific examples should be added to paragraph B31, especially to items (b), (g), and (h) as excerpt below, in order to make the requirements more readily understandable.

<Paragraph B31 of the proposed standard >
(b) The seller/lessee guarantees the buyer/lessor's investment or a return on that investment.
(g) The seller/lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer/lessor.
(h) The seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the transferred asset from the buyer/lessor.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Comment:

We agree to the proposal.

If the performance obligation approach is to be used, it will be appropriate to present the interest income, lease income, and depreciation expense separately, as proposed by the IASB.

Question 16 - Transition

(a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why? (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not? (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Comment:

We believe that the fully retrospective approach should also be permitted in addition to the proposed approach.

Under the proposed approach, all leases will be regarded as substantially commencing from the application date. As a result, accelerated recognition of costs of the lessee will begin at the application date collectively, and the costs incurred during the period immediately after the application date will become greater, which may distort the actual state of profit or loss. Therefore, we suggest that the fully retrospective approach should also be permitted.

If the fully retrospective approach is to be adopted, it may be difficult to manage the estimates from prior periods in practice. This, however, could be overcome by using an approach similar to the first-time adoption approach for decommissioning liabilities (paragraph D21 of IFRS 1 *First-time Adoption of International Financial Reporting Standards*).

Other comments

Question 18

Do you have any other comments on the proposals?

Comment:

(1) Clarification of the treatment of residual assets under the derecognition approach

We believe that the standard should clarify whether or not residual assets are to be depreciated under the derecognition approach for the lessor.

Whether or not to depreciate the residual assets over the lease term depends on whether those assets devalue over the lease term. For example, we propose the following:

(a) for the lease of a vehicle, the lessor should not depreciate the residual asset if the vehicle is left unused throughout the entire lease term; and

(b) if a lessor leases only a part of its own building and uses the rest for its own purposes, the lessor should depreciate the residual asset.

(2) Clarification of the treatment of various taxes

The standard should clarify the point that the lease payments do not include various taxes to be paid by the lessor, which will be reimbursed to the lessor at a later date by the lessee. This is clearly stated in the current IAS 17, but not specified in the proposed standard. A clear statement on this point will be necessary in the final standard to avoid confusion in practice.

Yours faithfully,

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