



The Association of
Accountants and
Financial Professionals
in Business

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Dear Chairmen:

The Financial Reporting Committee ("FRC") of the Institute of Management Accountants ("IMA") is writing to provide its views on the alternatives for lessee cost allocation under consideration by the Boards in the Leasing project. We understand that this issue is the subject of a user and preparer outreach effort and we applaud the Boards' decision to undertake this process.

The FRC is the financial reporting technical committee of the IMA. The FRC includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts¹. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

The outreach materials prepared by the FASB and IASB Staffs present four alternatives for the day 2 accounting, summarized as follows:

Alternative A: Depreciate the right to use asset on a straight-line basis and account for the liability under the interest method. This results in front-ended loaded expense for the lease contract.

Alternative B: Depreciate the right to use asset using an annuity method and account for the liability under the interest method. This results in a level expense charge for the lease contract in most cases.

Alternative C: Depreciate the right to use asset in two components: (1) the part to be consumed, amortized on a straight line basis, and (2) an amount necessary to compensate the lessor for "borrowing" the residual value, amortized on an interest method. This results in front-end loading of

¹ Additional information about the IMA's Financial Reporting Committee can be found at www.imafrc.org.

expense for the lease contracts to the extent of consumption and level expense for assets that are not consumed over the lease term (e.g., land).

Alternative D: Accounts for the lease contract as a whole. Results in essentially the same expense pattern as an operating lease under existing GAAP. Recognize a right to use asset and lease obligation each reporting period in an amount equal to the present value of the future lease payments.

Overall, we believe that Alternatives A through C are more operationally complex than is necessary to accomplish the broader objectives for this project. As requested in the outreach materials, we explain our views on Alternative C in more detail in the attachment to this letter. We urge the Boards to think about an approach that will accomplish the overriding goals of reflecting lease obligations on the balance sheet and eliminating the artificial distinctions between types of leases in a manner that will be understandable to investors and operational for preparers to apply. We believe that the fourth alternative accomplishes these objectives and therefore merits serious consideration by the Boards. We also believe that the scope of the standard should be crafted in such a way that all leases that are in-substance purchases should be accounted for as such (see our comments on page 4).

We recognize that it is unlikely that there will ever be unanimity in support of any of these alternatives; leasing spans such a broad range of transactions that it is difficult to produce an effective general model. On balance, as we consider the different points of view, Alternative D seems to be the most responsive to the important issues that have been raised regarding this matter. Specifically, we believe that it is consistent with the economics, is an improvement in financial reporting by achieving the two primary goals of the project and not requiring creation of yet another method of amortization method for assets. In the paragraphs that follow, we further explain the basis for our support for further consideration of Alternative D.

In the Boards' recent deliberations, there has been an extraordinary level of effort and attention devoted to various models for the subsequent accounting for the right to use asset. Each of the methods discussed at the February 2012 Board meeting entails increasing levels of complexity, varying degrees of conceptual merit, and/or unique financial reporting implications. In our view, these implications result from providing financial statement recognition for a special type of executory contract: one that is partially fulfilled through the delivery of the leased asset but continues to be fulfilled over the lease term as it is used (consumed) by the lessee and rent is paid. It is important to note that how the liability is defined in the proposed standard (e.g., the treatment of renewals, contingent rentals, etc.) will determine the amount recognized as the right to use asset and that it, therefore, could represent a broad range of values. Said differently, the right to use asset is a man-made, accounting construct whose size could vary substantially depending on the principles established by standard setters. Accordingly, that appears to suggest that there is not a strong independent economic basis for evaluating the right to use asset separate and apart from the liability that together represent the lease contract. We believe that this points to an approach that does not focus exclusively on the right to use asset as though it is free-standing and requiring accounting similar to other long-lived assets.

Given that we believe most preparers have now accepted balance sheet recognition as the fundamental outcome of this project, we ask the Boards to consider whether it is necessary to also change the cost allocation pattern. Investors' views are diverse, with many appearing to favor the P&L pattern (and often the same expense categorizations) provided under existing GAAP. Preparers largely disagree with the front-end loading of expense because they do not believe that it matches the pattern of use and benefit derived from the leased asset. For reasons outlined below, we believe that there is a

basis for the Boards to be pragmatic and find common ground on the cost allocation issue in a way that accomplishes the desired improvements in financial reporting that are the impetus for this project.

The inherent linkage between the asset and liability for lease contracts

As discussed above, we believe that lease contracts are a special type of executory contract. The asset being leased is available for use at the inception of the contract but performance through usage and payment of rentals is still required to fulfill the contract. We believe that delivery of the asset and the obligation it creates for the lessee to make the payments over the remaining term is a reasonable basis for recognizing this contract on the balance sheet. We believe that this treatment brings added transparency to financial statement users. However, it is critically important not to lose sight of the fact that such recognition does not alter the legal and economic linkage between the asset and liability which are components of a single contract. The lease contract has one set of economics not two, and they are reflected in the payments made by the lessee. We do not see a basis for evaluating the economics of the right to use asset independently from the contract as a whole. To illustrate, we offer the following points in the context of an example.

Consider a 5-year lease contract for an asset that has an economic life of 10 years and has level lease payments of \$500 per month.

- The economics of this contract is the \$500 monthly lease payment for use of the asset.
- The contract is not economically more expensive, or more useful, to the lessee in month 1 than it is in month 60. It is a rental that provides equal utility over the lease term.
- Unlike a purchased asset, the leased asset cannot be sold, pledged or otherwise disposed of separate and apart from the lease obligation.
- The lease obligation recognized results solely from, and is inextricably linked to, the underlying leased asset

Alternatives A and C seek to require a “pro-forma” presentation, as if an asset was purchased with financing and it is that objective that seems to be at the root of the concerns raised by constituents. A different view of this transaction which we believe is more straight-forward and representationally faithful is as follows: (1) a lessee is using the asset but doesn’t have ownership rights, (2) since the asset is not owned, the income statement correctly portrays the payments as rentals, and (3) on each balance sheet date, there is a need to recognize an updated amount for the “right to use” at the present value of the future rentals. There is no need to consider amortization per se, as the income statement already correctly reflects the economics of the transaction.

Models that do not appropriately portray these economics by requiring separate and independent accounting for a hypothetical purchase of the underlying asset and incurrence of imputed debt appear to us to undermine the benefits of making this accounting change. These approaches seem inconsistent with the economics of the lease contract and are not representative of the actual rights and obligations of the lessee under the agreement.

Effect on financial reporting

For reasons outlined above, we believe that it is not appropriate to require the accelerated recognition of expense under Alternatives A and C. The rationale for such a change in the pattern of expense recognition from existing GAAP is that the accounting treats the components of the lease contract as if they were separate and independent. Simply stated, the argument is that the expense pattern has to change because the lease contract is brought on balance sheet. In our view, that is not an explanation that many investors will find helpful and it gives rise to a financial reporting result that may not be

useful. Since financial statements are prepared for the benefit of investors, we believe that it is insufficient to offer a rationale for this change that is understandable mainly to accountants.

In addition, all of the alternatives except Alternative D appear to separate the financial effects of the lease contract into different categories in the Statement of Earnings and the Statement of Cash Flows. In our view, these changes inappropriately separate the economic cash outflows of the lease and will cause many analysts and other financial statement users to make adjustments to put them back together. Similar to the expense pattern observation above, these changes are proposed so that a lease mirrors the purchase of an asset with financing. As noted above, this depiction is inconsistent with the legal and economic characteristics of a lease transaction.

It is noteworthy that substantially all of the constituent concerns about the existing accounting model for leases focus on the bright lines and off-balance sheet nature of the obligation. We are not aware of any concerns or criticisms related to the pattern of expense recognition and the presentation of the rental costs as part of operating margin in the Statement of Earnings and as an operating cash flow in the Statement of Cash Flows. To the contrary, the Boards have heard ample feedback that many users do not want to see these aspects of lease accounting change. Alternative D addresses the weaknesses in the existing model without changing those aspects of lease accounting that investors agree with.

We also note that having an equal asset and liability at each balance sheet date throughout the lease term makes sense (absent an impairment event). The Boards have implicitly recognized that result in the proposed guidance for recording leases in purchase accounting. If the lessee is acquired part way through the lease term, the Boards propose that the leased asset and liability be set at equal amounts, adjusted for any off-market terms. Absent a change in market rental levels, a party would presumably be willing to assume the lease and record an asset of equal amount.

Complexity and cost

We observe that the population of lease contracts typically is bi-modal, with a very large number of individually small lease contracts (e.g., office equipment, computers, etc.) and a relatively small number of large contracts for major assets such as real estate. It is critically important that whatever model is developed can be applied in a cost effective manner at the individual unit of account level (the lease contract). At the small end of the leasing spectrum, the number of contracts can number in the tens of thousands for large companies.

Alternatives A through C are substantially more complex than what is done today in practice. The advantage of Alternative B is that preparers can address the large volume of small contracts in a relatively straightforward way through application of existing materiality concepts. This is not the case for Alternatives A and C.

We believe that Alternative D is the simplest and most straightforward of all of the alternatives. While it will entail changes in systems and reporting, the cost of those changes will be a fraction of the costs associated with Alternatives A and C.

Scope

We would propose that the scope of the proposed standard exclude lease arrangements that are effectively acquisitions of the underlying asset. We believe that such arrangements should be accounted for as owned assets. We believe that this approach avoids the necessity of prescribing two accounting models within the proposed lease standard. It also eliminates the subjectivity and interpretive complexity and possible structuring associated with the present bright line tests (or other methods) to distinguish operating and capital leases. Our sense is that this is quite similar to the proposal in the Boards' 2010 Leasing Exposure Draft to scope out in-substance purchases. We agree

conceptually and operationally with that approach. As we have noted, a "True Lease" is economically different from a purchase.

Conclusion

We believe that recognizing the lease contract on the balance sheet should not change either the nature of the expense or the pattern of allocating the cost of a lease over its contractual term. Moreover, we believe that it is imperative that the Boards find a solution that is simple and cost-effective for companies to apply. We believe Alternative D has merit and is worth pursuing as the way forward.

Members of the FRC would be pleased to answer in questions you may have regarding our response. Please feel free to contact me at (212) 664-1733 if you would like to discuss specific matters addressed herein.

Sincerely,



Allan Cohen
Chair, Financial Reporting Committee
Institute of Management Accountants

Attachment Views on Alternative C

As the Boards have asked for feedback on Alternative C, the Underlying Asset Approach, we have are providing the FRC's views on that approach below.

We find Alternative C to be, by far, the most complex and costly of the approaches under consideration by the Boards. The approach requires the lessee to obtain information about the fair value of the leased asset at lease inception, the fair value of the future residual value or the percentage of consumption during the lease term, which in many cases may not be available or possibly even determinable, particularly by lessees.

From a financial statement user standpoint, we do not believe that the results of applying Alternative C are helpful to investors, without regard to whether they view leasing as a financing activity or an operating activity. Those who view leasing as a financing activity would treat leases as an asset purchase financed with debt and do so on all three financial statements. They believe the asset purchase should be reflected consistent with all asset purchases; capitalize and amortize. As for the related obligation, the interest method would be used. In contrast, those who view leasing strictly as an operating activity would follow an approach that is similar to existing GAAP but would make an exception for leases that are in-substance purchases.

Alternative C provides an accounting result that is responsive to neither of these user views. Perhaps, with time, financial statement users could be educated on the model and eventually understand it and embrace it. But, as of now, we sense that it has no following in the user community.

We also struggle with Alternative C for conceptual reasons. We understand that it, in effect, asks the lessee to divide the ROU asset into two parts: (1) the part to be consumed and amortized straight line and (2) a part (a cost) to compensate the lessor for "borrowing" the residual value which would be amortized using the interest method. Not only is this complicated to do and explain, it does not reflect the economics to the lessee. The lessee did not acquire two assets. A lessee is simply paying rent for the use of the asset. The goal of financial reporting for this transaction should not be to impute the lessor's pricing algorithm into the financial statements of the lessee.

We understand that Alternative C was created, in part, as a response to preparer concerns about the pattern of expense recognition. While we appreciate the efforts to address those concerns, we do not find the alternative approach helpful in that regard. Preparers generally disagree with front-ended loading of expense but find this to be particularly troubling in the case of leased assets that amount to little more than short or medium-term rentals. This end of the leasing spectrum is the furthest away from acquisitions of large capital equipment and real estate. These are the type of transactions that would make the most sense to account for as rentals using some form of straight expense pattern. As they typically have more than insignificant consumption over the lease term, they will get the front-end loading of expense under Alternative C.

Overall, we are concerned that Alternative C does not address the preparer issues with Alternative A but adds substantial costs and complexity. We question whether it is operational to apply and conceptually sound. In addition, we are not sure how to handle the following under Alternative C: contingent rent, negative consumption, lease renewals (e.g., redo computations?), and changes in estimates.