



December 9, 2010

Technical Director
File Reference No. 1850-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Comments to Exposure Draft on Proposed Accounting Standards Update of Leases (Topic 840)

Dear Sir or Madam:

We appreciate the opportunity to provide comments to the Financial Accounting Standards Board and the International Accounting Standards Board (collectively, the “Boards”) on the Proposed Accounting Standards Update Exposure Draft (“ED”) - Leases (Topic 840). This ED will impact Altria Group, Inc. and its subsidiaries (collectively, “Altria”) both as a lessor in large ticket leveraged leases and as a lessee. Our financial services subsidiary, Philip Morris Capital Corporation (together with its subsidiaries), maintains a portfolio of large ticket leveraged leases where they provided financing and is the beneficial owner in various trusts that are the lessor/owner in long-term contractual arrangements with third parties. Our operating subsidiaries, within the ordinary course of business, are lessees under numerous agreements to lease office space, warehouse facilities, land, and equipment.

As a lessor, the comments in this letter are based on our belief that the present accounting guidance should remain in place. We believe that the proposed changes to lessor accounting as presented in the ED do not improve the transparency of financial reporting for leasing transactions. For example, current accounting and financial reporting requirements for leveraged leases provide users of financial statements with an accounting treatment that more closely aligns with the cash flows and related economic yield on leveraged lease transactions. Existing leveraged lease accounting appropriately reports a leveraged lease transaction from the perspective of a financing lessor as opposed to an operating lessor. Additionally, the proposed guidance does not account for any accretion of the present value of the residual value in a leasing transaction, therefore treating the accretion on a cash basis, essentially recognizing such income when the residual value is ultimately received (despite a portion of such income being economically earned over the life of the lease). We believe that this distorts the accounting from

the true economics of the lease transaction and believe it is inappropriate not to recognize income on an earning asset.

From the lessee perspective, we are concerned that the costs to implement the proposed guidance will outweigh the benefits derived by users of the financial statements.

Our comments on specific questions posed in this ED are as follows:

Question 1: Lessees

- (a) Do you agree that a lessee should recognize 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 recognize amortization 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?

Answer 1: Lessees

- (a) While we agree with the concept that a lessee should recognize a right-of-use asset and a liability to make lease payments, and recognize the Boards' efforts to create greater transparency and comparability between entities, we believe the ongoing costs of complying with the proposed lessee accounting guidance will be significant and the inherent subjectivity in application of certain aspects, such as renewal options and contingent rentals, will not achieve the benefit of enhanced comparability. We believe that the disclosures currently required in the financial statement footnotes under U.S. GAAP provide sufficient, easily understandable, and relevant information to users without added complexity and subjectivity.
- (b) We agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments, however, we disagree with the use of the effective interest method to recognize interest because it results in a distortion of earnings. Under current accounting guidance for operating leases, rent expense is charged at a consistent rate over the lease term as the leased asset is used in the generation of revenue. This appropriately reflects the economic benefit the entity receives from the leased asset over the lease period. Under the proposed guidance, the effective interest method to accrue interest on the liability to make lease payments will result in the highest charge to earnings in the earlier years, with the charge decreasing in subsequent years. This treatment does not reflect the economic reality of the transaction, nor does it provide more meaningful information to financial statement users. Further, it creates greater disparity between the actual cash flows and expense recognition than the current accounting model. Therefore, we recommend that the interest component of the lease be recognized on a straight line basis over the life of the lease.

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?
- (c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

Answer 2: Lessors

- (a) If the Boards move forward with the guidance in the ED regarding the performance obligation or derecognition approaches, we have concerns with the process involved in making the determination of which approach to follow. Although the ED does provide a sample of factors that should be considered in the determination of which approach to apply (performance obligation vs. derecognition), the approach selected would likely be a subjective decision based on a determination of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. This subjectivity may lead to the use of different accounting approaches for leases with similar attributes. Rather than have companies assess which approach to apply on a lease by lease basis, we believe that the determination should be based on a lessor's business model as explained in paragraph BC27. The derecognition approach should only be used if a lessor's business model is to provide financing, and the performance obligation approach should be used by lessors that generate returns by managing assets in a manner similar to that of an operating lessor. Additionally, the evaluation of lessor lease classification at the portfolio or segment level would eliminate variability in applying the accounting standard to each individual lease and substantially reduce the cost burden. This approach is also consistent with the Boards' recent discussions on classification of certain financial assets based on the entity's business model.
- (b) Overall, we believe that the proposed changes to lessor accounting will not improve transparency of financial reporting of leasing investments for users of financial statements. Current accounting and reporting by lessors for operating, direct finance and leveraged leases continues to best represent to users of financial statements the economics of a leasing transaction, especially with respect to capital leases. This is because the pattern of net investment and earnings closely follow the economics in the transaction, including the yield on the after-tax cash flows. For example, lessor financing transactions are designed to recover principal and interest in a manner that closely follows the pattern of cash flows of the investment. We also believe that there are certain fundamental issues that exist with the proposed guidance. One such example is the inability for lessors to accrete the residual value in a lease accounted for in accordance with the derecognition approach. The increase in the time value of the residual represents

an integral component of a lessor's return on a lease investment and it would be inappropriate to ignore this earnings aspect of a finance lease during its life. This is also an example of where the accounting treatment under the proposed guidance does not align with the underlying economics. In addition, we disagree that, under the performance obligation approach, a lessor should record two assets when the lessee may record the same asset, and the entire physical asset of a lessor is encumbered by a lease agreement. We believe that a lessor has either a physical asset or a financing receivable. The inclusion of a corresponding performance obligation in the liability section of the balance sheet adds unnecessary complexity and reduces the clarity of the overall transaction.

- (c) We disagree with the conclusion that there should be no separate accounting for lessors with leveraged leases. Current leveraged lease accounting recognizes income at a level rate of return on the net investment over the life of a lease which reflects the pattern of cash flows and related economic yield. Therefore, current leveraged lease accounting provides financial statement users with a transparent understanding of these transactions. The accounting models in the ED do not improve financial reporting or increase transparency.

Another issue that needs to be addressed in the final guidance is the treatment of the nonrecourse debt if existing leveraged leases are not excluded (through grandfathering or otherwise) from the scope of the new standard. If adopted, what basis should lessors use to record the nonrecourse debt; amortized cost, the contractual balance or fair value? We believe that amortized cost from inception should be used as this would ease the transition to the new standard in so far as this information is readily available. However, we believe nonrecourse debt should be reflected as a contra asset in the balance sheet since the receivable is encumbered by the debt, the creditor (holder of the debt) controls all cash flows that finance the obligation and the lessor bears no risk to the nonrecourse debt in a leveraged lease. In addition, recording nonrecourse debt separately in the balance sheet will be misleading to users of the financial statements as it will be difficult to distinguish recourse debt from nonrecourse debt.

Question 5: Scope Exclusions:

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative would you propose and why?

Answer 5: Scope Exclusions:

We believe that the current leveraged lease accounting model should be maintained under the new guidance or, at least grandfathered, for leveraged leases already in existence on the date the new standard becomes applicable. As we stated in our response to Question 2c, we believe that separate accounting for lessors with leveraged leases should be allowed as currently permitted under U.S. GAAP because it provides financial statement users with a better understanding of the leveraged lease transactions. The accounting models in the ED do not improve financial reporting or increase transparency.

Question 8: Lease Term:

Do you agree that a lessee or 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?

Answer 8: Lease Term:

We do not agree with the concept of defining the lease term as the longest possible term that is “more likely than not” to occur. Estimating the probability of occurrence for each possible term will be a highly subjective exercise relative to current U.S. GAAP requirements. Although the proposed standard does provide factors to use in the assessment (paragraph B18), we believe that the subjectivity of this requirement would likely lead to inconsistent treatment of similar types of lease agreements. Additionally, there is potential for the overstatement of right-of-use assets and liabilities to make lease payments when including renewal periods that are calculated on a more likely than not basis. Complicating this further is the difficulty in assessing the impact of possible outcomes of the end of lease options for long-term leases. Hence, it is difficult to assess how much accuracy could really be achieved by assigning a probability percentage to the *possible* occurrence of renewing an option 10 or 15 years out in the future. Factors like the state of the economy and the ever-changing business environment make it extremely difficult to forecast with any level of confidence and accuracy for more than a few years into the future.

Therefore, we recommend the Boards revise the guidance to exclude optional lease terms unless contractual factors or business circumstances indicate renewal is highly certain. If the Board concludes that optional terms must be included, we believe that, at a minimum, the Board should provide a higher threshold than the proposed “more likely than not” criteria in determining the lease term. The higher threshold should be a “best estimate” or “most likely” criteria in order to minimize the high level of subjectivity and provide more meaningful information to financial statement users.

We also believe that options do not create a financial obligation until exercised. Liabilities are defined as “*probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events*”. Consequently, since a past event has not occurred that gives rise to a present obligation, it would be inconsistent with the definition of liabilities to include in the lease obligation, payments that would be triggered by options that have not been exercised at lease inception. The inclusion of periods covered by options in the lease term would overstate the liabilities of a lessee. In addition, this would cause the lessee’s total expense, including interest expense, to be overstated during the early part of the lease term.

For these reasons, we believe current guidance regarding lease terms should continue to be followed.

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 reliably measured? Why or why not?

Answer 9: Lease Payments:

We agree that residual value guarantees should be included in the measurement of assets and liabilities. We do not agree that contingent rentals and expected payments under term option penalties should be included in the measurement, of assets and liabilities using an expected outcome technique as we do not believe an asset or liability exists at lease inception for contingent events. Thus, contingent rentals that are based on future sales or units produced do not give rise to a liability at the inception of the lease because there has not been a triggering event to secure the unconditional obligation on the part of the lessee to pay. In addition, the subjectivity of and variability in estimating contingent payments and future changes in variables that may affect future contingent payments will lead to diverse outcomes and limit the comparability and transparency the Boards seek to achieve. Recording contingent payments as income or expense when they become receivable or payable, respectively, will provide for consistency in application as well as comparability.

We understand the Boards' concern that lessees may structure lease payments as contingent rents to avoid recognizing a liability, however at lease inception, the terms and conditions of each lease agreement should be carefully reviewed to make sure that assets and liabilities reflect the true economics of the transaction. Contingent payments that become unconditional during the term of the lease should be subsequently considered for adjustment.

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?

Answer 10: Reassessment:

We do not agree that lessees and lessors should remeasure assets and liabilities for any changes resulting from reassessment of expected values or estimates. These changes do not represent changes in contractual rights or obligations. Leases should only be remeasured for changes in lease agreements. This is consistent with what is required under current U.S. accounting guidance for a lease that is revisited if the provisions of a lease are changed.

While we appreciate the Boards' attempt to reduce the impact of reassessment by limiting the requirement to significant changes, we believe that complying with the requirement will still be

costly and administratively burdensome. In order to determine that a significant change has occurred, the population of leases must be monitored and reviewed on an ongoing basis. Furthermore, allocating changes in contingent rentals, term option penalties, and residual value guarantees to current, prior, or future periods may also be challenging requiring significant changes to accounting systems to enable such allocation. Due to the cost/benefit constraint, we believe that only material changes in the lease agreement should require a reassessment.

As indicated in our response to Question 9, we believe that only contingent rents or payments from term option penalties that become unconditional obligations should be considered assets and liabilities and thus would only then need to be considered for reassessment.

Question 12: Statement of Financial Position:

- (a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

Answer 12: Statement of Financial Position:

- (a) We agree that lease liabilities should be stated separately from other financial liabilities to achieve transparency. We also agree that the right-of-use assets should be separately stated from other components within property, plant and equipment, since these assets have different financial risks and are not owned by the lessee.
- (c) If the derecognition approach is required in the final standard, then we agree that in applying the derecognition approach, rights to receive lease payments should be presented separately from other financial assets. However, we disagree with presenting the residual asset within property, plant and equipment. Instead, it should be listed separately, in the aggregate, as a sub-component of lease receivables. The residual value does not represent a fixed asset of the lessor because it is not available to the lessor during the lease term and may be sold at or before the end of a lease term. In practice, in a financing transaction, the lessee, or a third party, may purchase the asset at lease end or sooner. From a lessor perspective, the residual value is integral to the overall return on investment and we believe should be treated in a manner similar to a final payment on a lease, as is currently the case under a sales-type or direct financing lease. We also believe that this supports a full derecognition model. In a financing arrangement, the lessor is not in the business of servicing the asset as is typical in an operating lease and, while residual value is an important component of a lessor's economic return, there is no certainty whether there will be additional upside or downside at lease-end.

Question 13: Income Statement:

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Answer 13: Income Statement:

From a lessee perspective, we do not see any benefit to presenting amortization expense associated with the right-of-use assets and interest expense associated with the liabilities to make lease payments separately on the income statement. We believe that disclosure within the footnotes to the financial statements would be sufficient to highlight the expenses related to these leases. If a decision is made to show these items separately in the income statement, we believe this should be delayed and included within the financial statement presentation project.

Question 14: Statement of Cash Flows:

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows? Why or why not? If not, do you think that a lessee or a lessor should disclose the information in the notes instead? Why or why not?

Answer 14: Statement of Cash Flows:

We agree that lessees should classify separately cash flows arising from leases in the statement of cash flows; however any changes should be delayed and included in the financial statement presentation project.

Question 15: Disclosure:

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's cash flows?

(paragraphs 70-86 and BC168-BC183)? Why or why not? If not, how would you amend the objectives and why?

Answer 15: Disclosure:

We agree that both lessees and lessors should disclose quantitative and qualitative information that identifies the significance of leases in the financial statements as well as how the leases may affect cash flows. With respect to lessor accounting, it would benefit financial statement users if the disclosure provided the nature of the lease agreements, in particular information about the exposure to the risks or benefits of the underlying asset that are used in determining whether to apply the derecognition or performance obligation approach. Disclosure should be provided for

