



The Association for
Accountants and
Financial Professionals
in Business

March 9, 2010

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
United Kingdom

Mr. Robert Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Lessor Accounting

Dear Sirs:

The Financial Reporting Committee ("FRC") of the Institute of Management Accountants ("IMA") is writing to share its views on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) tentative conclusions on a lessor's accounting for leases. While we understand the Boards intend to issue an Exposure Draft for comment, we would like to share our views on the direction the Boards are taking on lessor accounting in the hope that the Boards will reconsider their tentative conclusions prior to issuing the Exposure Draft.

FRC is the financial reporting technical committee of the IMA. The committee 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 analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

We disagree with the tentative conclusion requiring a lessor to recognize a performance obligation equal to its asset for the present value of the lease payments it expects to receive over the term of the lease. We believe that tentative conclusion is fundamentally inconsistent with the Boards' decisions on their revenue recognition project and leads to results that we believe are inaccurate, counterintuitive, and misleading. We believe the Boards should adopt the partial derecognition approach as it is consistent with the Boards' decisions on revenue recognition and the conceptual framework. The Boards defined a performance obligation in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* as:

... a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer.

Under the model proposed in the Discussion Paper on revenue recognition, a company would recognize revenue when it fulfills its performance obligation (that is, when it transfers the asset or provides the service to the customer). Paragraph 4.5 of the Discussion Paper states, in part:

... the customer has the promised asset when it controls the resource underlying that promised asset. Accordingly, to determine when a good is transferred to a customer, an entity assesses whether the customer controls the good so that the good is the *customer's* asset. Typically, the customer controls the good when it takes physical possession of the good.

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Further, in the Discussion Paper *Leases: Preliminary Views*, the Boards concluded that the lessee's right to use the leased asset qualifies as an asset to the lessee because, as stated in paragraph 3.16 of the Discussion Paper:

... the lessee controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract).

However, in their tentative conclusion on lessor accounting, the Boards have decided that the lessee's control over the asset is not relevant to the lessor's accounting. As summarized in the FASB staff minutes to the October 28, 2009 Joint Meeting between the FASB and the IASB, the Boards decided to adopt an approach to lessor accounting under which a lessor would:

- Recognize an asset representing its right to receive rental payments (a lease receivable).
- Recognize a liability representing its performance obligation under the lease—that is, its obligation to permit the lessee to use one of its assets (the leased item). The lessor would recognize revenue as that performance obligation is satisfied over the lease term. That means that a lessor would not recognize revenue at the inception of a lease contract.

The Boards' conclusion on a lessor's accounting for its performance obligation implies that the lessor has not transferred control over the leased asset. We believe that assumption is inconsistent with the legal rights and obligations of the parties to a lease agreement. Once the lessor has delivered the asset to the lessee, the lessor has no right to the economic benefits generated by the asset, at least during the term of the lease, barring an event of default.¹ Lease agreements commonly include "quiet enjoyment" provisions that prohibit the lessor from interfering with the lessee's use of the asset as long as the lessee's use complies with the terms of the lease agreement. As such, control over the asset during the lease term transfers to the lessee at the beginning of the lease term, which supports the Boards' decision to require the lessee to recognize an asset for its right to use the leased asset. It seems strange to us then that the Boards would conclude that the lessor transfers control to the lessee over the term of the lease rather than at the beginning of the lease term. We are not sure how to reconcile that inconsistency in the Boards' positions. We also cannot reconcile the Boards' preference for requiring gross presentation by the lessor of a receivable and a performance obligation, beyond its obligation for a single day, with the notion of net presentation in the Discussion Paper on revenue recognition. In the revenue recognition Discussion Paper, the Boards concluded that both parties to an arrangement would present the arrangement on a net basis until one of the parties performed. At that point, the parties would separately recognize the assets and performance obligations arising from the arrangement. If, as the Boards appear to believe, the lessor performs its obligation over the lease term, it is inconsistent to require the lessor to separately recognize an asset and a performance obligation for more than just each day's activity (since neither party has performed any activity that results in gross presentation for the remaining term of the lease).

¹ While the lessor has the right to sell the leased asset, that right is subject to the rights of the lessee and thus is economically limited to its interest in the leased asset's residual value. The lessor's right to the residual interest in the leased asset only gives it control over the economic benefits that remain upon expiration of the lease. The lessor has given the lessee the right to control the economic benefits from using the asset during the lease term, so it no longer has the right to obtain those benefits. In place of those economic benefits, the lessor is only entitled to the consideration set forth in the lease agreement. The lessor does have the right to sell or pledge its right to receive those future payments.



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In addition to being inconsistent with its conclusions on lessee accounting, we believe the conclusion on lessor accounting is inconsistent with the Boards' conceptual frameworks. Paragraph 25 of FASB Concepts Statement No. 6 *Elements of Financial Statements* defines "assets" as

... probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Footnote reference omitted.]

Paragraph 26 of Concepts Statement 6 states, in part:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

Similarly, paragraph 89 of the IASB's *Framework for the Preparation and Presentation of Financial Statements* states:

An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

We agree with the Boards that the right to receive lease payments over the lease term qualifies for recognition by the lessor as it is probable that the future economic benefits associated with those payments will flow to the lessor. However, we believe Concepts Statement 6 and the Framework support requiring the lessor to derecognize the portion of the asset that corresponds to the future economic benefits transferred to the lessee. The lessor no longer controls access to the future economic benefits associated with the use of the leased asset, having exchanged its right to control that access for future payments by the lessee. We recognize the measurement issues this raises in terms of allocating the cost of the asset between the portion transferred and the portion retained, but we would rather the Boards address those issues than require lessors to continue to recognize an asset they do not control.

Finally, we disagree with the arguments against the derecognition approach in paragraphs 18 to 29, and for the performance obligation approach in paragraphs 53 to 58, in the IASB Agenda Paper 10C/FASB Memo 43 prepared for discussion at the Boards' October 28, 2009 joint meeting. Those arguments, and our responses, generally fit within the following categories:

- *The leased asset continues to generate cash flows to the lessor.* The lessor has exchanged the right to use the asset to generate cash flows for the right to receive payments from the lessee. The lessee has the right to use the asset to generate cash flows.
- *The lessor controls the right-of-use of the leased asset by deciding to enter into a lease to generate cash inflows.* We agree with this argument, but believe it is not relevant. We do not believe financial statement users are concerned with the lessor's accounting prior to its entering into a lease agreement. We believe they are concerned with the lessor's accounting after it enters into the lease. For this argument to have merit, one would have to argue that entering into a lease is not a significant event, which presumably works against requiring the lessor to recognize a receivable for amounts it is entitled to receive under the lease, yet the Boards have so concluded.

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- *A derecognition approach would lead to the leased asset not appearing on either party's balance sheet.* While technically correct when the focus is on the whole asset, we do not believe it has merit. Under our proposal, the lessee will have recognized an asset for its right to use the asset and a liability for its obligation to make payments to the lessor. The lessor will derecognize the portion of the recorded amount of the asset corresponding to the future economic benefits it transferred to the lessee, but will continue to recognize its interest in the leased asset's residual value (which should equal the fair value of the future economic benefits the lessor controls). We see no virtue in requiring the lessor to record the asset in full when it only controls a portion of the future economic benefits simply so that an entire asset will appear on someone's balance sheet.
- *Lessors would have a difficult time applying a derecognition approach for short-term leases or leases in which the lessee obtains the right to use a portion of a larger asset.* We believe short-term leases will present difficulties for lessees and lessors, regardless of the model the Boards pursue, which is why we recommended the Boards provide an exemption for short-term leases in our comment letter on the Discussion Paper. If the Boards do not provide an exemption, we assume lessees and lessors will rely on materiality arguments to not recognize an asset and liability or derecognize a portion of the leased asset. We note that difficulties arise today in leases involving a portion of a larger asset. The current approach in paragraph 28 of FASB Statement No. 13 *Accounting for Leases* (ASC section 840-10-25-69) is to require operating lease accounting by a lessor if it cannot objectively determine either the cost or fair value of the portion of the asset subject to the lease. In keeping with the Boards' view that a lessor should recognize an asset for the future minimum lease payments, we believe the Boards should consider proposing that the lessor recognize a performance obligation if it is unable to objectively determine either the cost or fair value of the portion of the asset subject to the lease.
- *It is difficult to track and reconcile the deferred tax implications under the derecognition approach.* The Boards have issued other pronouncements over the years that have required companies to track the deferred tax implications for transactions or events (for example, share-based payment arrangements). We do not see how the difficulty of tracking the deferred tax implications under the derecognition approach justifies adopting an approach that is at odds with the Boards' conceptual frameworks.
- *It is possible that a lessor could derecognize an asset that continues to have material economic value to it after the end of the lease term.* We do not believe this is a serious issue if the approach requires the lessor to recognize the residual interest at an amount equal to the estimated fair value of the asset at the end of the lease term. If the asset will truly have material economic value to the lessor at the end of the lease term, presumably the lessor will reflect that value in the recorded residual. We note that lessors make such estimates today when they record a direct financing or sales-type lease.
- *It will be difficult to estimate the leased assets' residual value.* As noted above, lessors estimate the leased asset's residual value under today's guidance. While it may be difficult to estimate the fair value of the leased asset at the end of the lease term, we do not believe measurement uncertainty is a basis to require the lessor to continue to recognize an entire asset it does not control.
- *There is uncertainty over how a lessor would account for a sale of the leased asset if it previously derecognized the asset.* This argument is related to the prior two arguments. If the lessor recognizes an asset for its interest in the leased asset's residual (as it would do under the derecognition approach), it will have an asset to which it will apply the derecognition guidance.

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- *The performance obligation approach would be consistent with the approach to revenue recognition in the Discussion Paper if one views the lease as the transfer of a service the lessor provides over the lease term. The lessor does not lose control of the asset during the lease term. We believe defining an arrangement as something it is not does not provide an appropriate basis for a conclusion. The lessee controls the use of the asset, even if the arrangement requires the lessor to provide significant services to the lessee over the term of the lease. We believe the Discussion Paper on revenue recognition would require the lessor to separate such arrangements into their individual elements. The delivery of control over the asset to the lessee would satisfy one performance obligation. If the lease required the lessor to provide specified services over the lease term, the lessor would recognize a performance obligation for those services, just as a seller would do. The argument that the lessor does not lose control of the asset during the lease term is inconsistent with the rights and obligations of parties to a lease agreement. As noted previously, as long as the lessee complies with the terms of the lease agreement, it will control the use of the asset (conversely, the lessor will have no right to control the use of the asset as long as the lessee is not in default).*

The fact the Boards are now wrestling with how to define “in-substance” sales highlights the weakness in their proposed approach to lessor accounting. If the Boards focused instead on the rights of the parties to the economic benefits of the leased asset and required each party to account for the economic benefits to which they are entitled, the Boards would not have to define an “in-substance” sale. As an extreme example of what we believe is the logical outcome of the performance obligation approach, assume that a lessor transfers an asset to the lessee for its entire remaining economic life in exchange for future payments, the present value of which equals the fair value of the asset at the inception of the lease. In that situation, the lessor would have to retain the leased asset on its balance sheet, even though it has no meaningful interest in the asset apart from its ownership of the asset. We do not believe such a presentation would be meaningful to financial statement users. In summary, the performance obligation approach results in recognizing incremental assets and liabilities that do not exist.

We encourage the Boards to adopt the partial derecognition approach as it is consistent with the conceptual framework and would avoid requiring a separate model from the one the Boards are developing in their revenue recognition project. However, if the Boards continue to reject the partial derecognition approach, we believe they should drop lessor accounting from the scope of the leasing project. Lessor accounting today does not suffer from the same problems as lessee accounting and, in our view, the proposed performance obligation approach is not an improvement over the current lessor accounting model.

We appreciate the Boards consideration of our comments. We would be pleased to discuss our comments with the IASB and FASB staff at their convenience. I can be reached at 00 1 (513) 983-6666.

Sincerely,

Mick Homan
Chair, Financial Reporting Committee
Institute of Management Accountants