The Association of Accountants and Financial Professionals in Business

April 18, 2014

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Subject: Lease Accounting Project

Dear Sirs:

The Financial Reporting Committee (FRC) and the Small Business Financial and Regulatory Affairs Committee (SBFRC) of the Institute of Management Accountants (IMA) are writing to provide their views to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB, and collectively, the Boards) on the tentative decisions reached at the joint meeting on March 18 and 19, 2014.

The IMA is a global association representing more than 65,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The 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 SBFRC addresses issues that impact small and medium-sized organizations. Information on both committees can be found at www.imanet.org under the Advocacy section.

We continue to support the Boards' decision to reconsider the accounting for leases, and we believe that lessees should reflect an asset and a liability for substantially all leases. We also continue to support convergence. As such, we were disappointed that the tentative decisions reached at the latest meeting would, if adopted as final, lead to significant differences in both lessee and lessor accounting. We have the following comments on the Boards' tentative decisions.

Lessee Accounting

We agree with the FASB's decision to adopt "Type B" accounting for leases that do not transfer control over the asset to the lessee and that the criteria in International Accounting Standard (IAS) 17 *Leases* should be used in making that distinction. While there have been comments about the complexity of a "dual model" approach, the "Type B" accounting model will not have any incremental impact on complexity. Preparers and auditors currently distinguish between arrangements that transfer substantially all risks and rewards (i.e., control) of the asset to the lessee and those that do not. In our view, the classification issue is a question of scope. If an arrangement transfers control over substantially all of the future economic benefits of an asset to the lessee, the arrangement is effectively not a lease. It is, in substance, a purchase by the lessee and a sale by the lessor. As we recommended in our comment letter on the 2013 Exposure Draft, we believe the Boards should exclude in-substance purchases from the scope of the leases guidance. We do not believe there is any disagreement over the subsequent accounting for an in-substance purchase of an asset, even if the arrangement is documented as a lease. What would remain within the scope of the leases guidance would be arrangements that are economically different from arrangements where the user obtains control over substantially all of the future economic benefits of the asset. Because the criteria in IAS 17 can be used in distinguishing between arrangements that transfer control over substantially all of the remaining economic benefits of an asset to the user and arrangements that do not, and because preparers and auditors are very familiar with applying those criteria, the proposed model would not increase complexity.

We understand that some users would like the accounting for leases of equipment to be the same as purchases of equipment. However, we do not believe that the accounting for an asset purchase (for example, a five-year lease of equipment with an economic life of five years) should be the same as a lease (for example, a five-year lease of equipment with an economic life of 30 years). The economic rights of the lessees in those examples are different and the accounting should not ignore those differences.

While we understand that members of the IASB were concerned that the amortization of the right-of-use asset under "Type B" accounting would differ based on the timing of payments under the lease, focusing solely on amortization expense ignores the linkage between the right to use the asset and the financing that is particular to leasing arrangements. Because the use of the asset under a lease is not separable from the financing, we believe a lessee should allocate the total cost of the arrangement (both interest charges on the financing and any charge for the use of the asset) over the lease term (the period that the lessee benefits from having access to the asset), presumably on a straight-line basis. In contrast, if the arrangement is an in-substance purchase of the asset, the decision on how to finance the purchase is independent of the cost of the asset and, therefore, should not affect the cost of the asset to be allocated over the period that the in-substance purchaser benefits from using the asset. We believe that the "Type B" accounting approach adopted by the FASB recognizes the linkage between the right to use the asset and the financing provided and more appropriately accounts for the economic differences between arrangements that are in-substance purchases of assets and arrangements that are not. When the benefit the lessee receives from having access to the asset is the same each year, the lessee should allocate the cost of the lease on a straight-line basis over the lease term. To do otherwise is to ignore the economic differences between a lease and a purchase.

We disagree with the proposed exemption from the recognition and measurement provisions for small-ticket leases and encourage the FASB not to provide an exemption. We believe such an exemption is contrary to the original purpose of the leases project, which was to require the recognition of all material right of use assets and lease obligations. Further, we believe the Boards have made other decisions that will reduce the costs of implementing the revised guidance, principally the decision to use the proposed definition of "lease term" to determine whether a lease qualifies for the short-term lease exemption. Finally, we note that if the amount of small-ticket leases is not material, companies will not need to apply the provisions of the proposed standard to those agreements. The Boards should not provide exemptions for what could be material right of use assets and obligations. If the purpose of the small-ticket lease

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exemption is to ease the application of "Type A" accounting, we would encourage the IASB to reconsider its support for "Type A" accounting in light of the primary issue the project was intended to fix – the recognition of leases on the balance sheet.

Even if the FASB decided to permit an exemption for small-ticket leases, we do not believe that decision should affect the tentative decision to adopt the "Type B" accounting model. If the Boards decide to effectively exclude small-ticket leases from the scope of the proposed standard, the majority of the arrangements that remain, by dollar amount, will involve real estate. We understand that many users of financial statements of companies with significant real estate leases prefer the expense recognition pattern of existing operating lease accounting (that is, "Type B" accounting). We also understand that, when there is competing conceptual support for more than one proposed accounting alternative, which we believe to be the case here, the Boards will consider the views of users.

Lessor Accounting

We agree with the Boards' decision to discontinue discussion of the receivable-and-residual approach, but we are concerned that each Board's decision will result in inconsistencies with the forthcoming revenue recognition standard. We understand the Boards' desire not to significantly amend the existing classification criteria in IAS 17, but we believe those criteria are, in one respect, inconsistent with the guidance in the revenue recognition standard. For example, consider an arrangement that requires a lessee to make payments equal to 100% of the leased asset's fair value at inception, but where the lessor provides a guarantee that the lessee will realize proceeds equal to at least 40% of the leased asset's fair value (which is expected to equal the leased asset's fair value) if the lessee sells the asset at a specified future date. If the lessee does not elect to sell the leased asset at that time, the lessor will transfer title to the lessee. Based on the criteria in IAS 17, we believe the lessor would classify the lease as an operating lease because of the following.

(a) The lease does not automatically transfer ownership of the asset to the lessee by the end of the lease term (the lessee has to decide to forego the resale price guarantee provided by the lessor and not sell the leased asset).
(b) The lease does not include a purchase option that is exercisable at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable so that it is reasonably certain that the option will be exercised (the resale price guarantee provided by the lessor is expected to equal the fair value of the asset at the time the lessee's option to sell the asset and terminate the lease becomes exercisable).
(c) The lease term is not for the major part of the economic life of the asset (fact is assumed).
(d) The present value of the minimum lease payments (lease payments of 100% less the lessor guarantee of the resale value of 40%) does not amount to substantially all of the fair value of the leased asset.
(e) The leased asset is not of such a specialized nature that only the lessee can use it without major modifications (fact is assumed).

However, if the criteria in the revenue recognition standard were applied to the transaction, we believe the lessor/transferor would recognize a sale, but would likely be required to allocate a portion of the arrangement consideration to the guarantee obligation.

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In addition, we disagree with the Boards' decision to permit lessors to recognize dealer profit on a lease – albeit in different periods – in situations where the lessor has not transferred control over substantially all of the remaining future economic benefits to anyone (i.e., when it has obtained a third-party residual value guarantee so that the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset). If the transaction were subject to the revenue recognition standard, the transferor would be prohibited from recognizing a sale. In circumstances where there is a dealer profit, we believe a lessor should determine the accounting for the profit as follows.

- First, the lessor should determine the classification of the lease as a financing or operating lease. We agree with how the Boards have proposed making this determination; that is, we agree that the involvement of third parties (whether or not related to the lessee) should be considered in determining whether the lease is a financing arrangement.
- Then, the lessor should determine whether the lease transfers control over substantially all of the remaining economic benefits of the asset to the lessee. In making this determination, the lessor should not consider the involvement of third parties unrelated to the lessee. If the lease does not transfer control over substantially all of the remaining economic benefits of the asset without considering the third party involvement, the lessor will defer the dealer profit until it does transfer control over substantially all of the remaining economic benefits associated with the asset.

The example in the Appendix illustrates the results of our proposed approach to lessor accounting when there is a dealer profit. Our proposed approach will make the leases guidance consistent with the criteria in the revenue recognition standard and will eliminate structuring opportunities that would otherwise be available. Further, excluding involvement by third parties unrelated to the lessee in determining whether the lessor has transferred control over substantially all of the remaining economic benefits would be consistent with the proposed definition of "lease payments" the Boards have previously exposed. We do not believe a change to our proposed approach would require re-exposure of the proposed approach for lessors, nor do we believe our proposed approach would be difficult for lessors to apply.

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We appreciate the Boards' consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely,

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APPENDIX

Facts

- Lessee and Lessor enter into a transaction to lease equipment for a non-cancelable four-year term;
- The lease does not contain renewal or purchase options;
- The equipment has an estimated remaining economic life of six years;
- The equipment has a fair value and a carrying amount of $50,000 and $45,000, respectively, at lease commencement;
- The equipment has an estimated residual value of $14,000;
- The lease payments are $11,000 per year (paid in arrears);
- Lessor's implicit rate is 5.392% using the fair value of $50,000;
- Lessor obtains a residual value guarantee from a third party with a net present value at lease commencement of $7,295; and
- At lease commencement, the present value of the lease payments, including the third-party residual value guarantee, is 92% of the initial fair value of the equipment. Excluding the third-party residual value guarantee, the present value of the lease payments totals 77% of the equipment's initial fair value.

Lease Classification

The lease would be classified as a finance lease based on the criteria in IAS 17 because the present value of the minimum lease payments (including the residual value guarantee as required by IAS 17) amounts to at least substantially all of the fair value of the leased asset at the commencement of the lease.

Because the fair value of the asset exceeds its carrying amount, Lessor determines whether it can recognize the profit based solely on amounts due from Lessee (or parties related to Lessee). As the present value of the lease payments, excluding the third-party residual value guarantee, does not amount to substantially all of the fair value of the leased asset at commencement, Lessor is required to defer the profit until such time as it does transfer control over the asset's remaining future economic benefits.

Lessor Accounting

Lessor would recognize its net investment in the lease and would derecognize the underlying asset. Lessor would measure the net investment in the lease at the present value of the lease payments plus the present value of the residual value less the deferred profit. Lessor would recognize interest income over the lease term on the recorded amounts of the lease receivable and residual value using the interest method.

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The table below summarizes the amounts arising in Lessor's statement of financial position and income statement under the proposed approach.

Statement of Financial Position					Income Statement			
End of year	Lease receivable[1]	Residual value[2]	Deferred profit	Net investment	Interest on receivable	Residual accretion	Earned profit	Total income
0	$38,653	$11,347	$(5,000)	$45,000	$ -	$ -	$-	$ -
1	29,737	11,959	(5,000)	36,696	2,084	612	-	2,696
2	20,340	12,604	(5,000)	27,944	1,603	645	-	2,248
3	10,437	13,284	(5,000)	18,721	1,097	680	-	1,777
4	-	14,000	(5,000)	9,000	563	716	-	1,279
Totals					$5,347	$2,653	$-	$8,000

[1] Represents the present value of lease payments that will be made by Lessee.
[2] Includes the portion of the residual value guaranteed that is by a third party.