The Association of
Accountants and
Financial Professionals
in Business

December 3, 2020

Ms. Hillary H. Salo, Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2020-700, Proposed Accounting Standards Update, *Leases (Topic 842) – Targeted Improvements*

Dear Ms. Salo:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update *Leases (Topic 842) — Targeted Improvements* (Proposed ASU).

The IMA is a global association representing over 140,000 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 FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The Committee appreciates the Board's decision to fix the problem of lessor's reporting "day one" losses on sales-type leases with significant variable lease payments and its efforts to eliminate one difference between the lessee-accounting models in Topic 842 and IFRS 16 *Leases* and ease the application of the guidance on accounting for lease modifications by lessees for modifications that reduce the scope of a lease. However, we have the following recommendations.

<u>Issue 1: Sales-type Leases</u>

While the Board's proposal will solve the most significant "day one" loss issues seen in practice, we are concerned that only permitting operating lease classification to leases where payments are predominantly (more than 50%) variable lease payments will not completely solve the issue. We believe a preferable approach would be for a lessor to classify as an operating lease a lease that would otherwise be classified as a sales-type lease if:

(a) classifying the lease would result in a loss at the lease commencement date and

(b) the lessor reasonably expects to earn a profit on the arrangement when considering the present value of the fixed lease payments, the variable lease payments it expects to collect, and the residual value at the end of the lease term that accrues to the lessor's benefit.

We do not believe this model would require any additional effort and would avoid an accounting result (i.e., a "day one" loss) that does not fairly represent the economics of the transaction. As the Board notes in paragraph BC13, a lessor "would have developed quantitative estimations to evaluate the expected profitability of a lease arrangement."

Issue 2: Option to Remeasure the Lease Liability

Proposed paragraph 4A of ASC 842-20-35 requires the lessee to "use a revised discount rate that reflects changes in the interest rate" when updating the measurement of the lease liability. While this wording is converged with IFRS 16, it would be helpful if the Board provided an example to show what it means by that wording. Does it mean, for example, that if the lease payment increases by 1% because LIBOR increased by 1% from the commencement of the lease that the lessee would simply increase the incremental borrowing rate by 1%? We understand that companies applying IFRS have had to apply similar guidance in accounting for financial assets and financial liabilities with floating rates, so it would be helpful if the example conformed to practice as it relates to those financial instruments. Further, many leases have payments that increase based on changes in the consumer price index. We assume that the change in the consumer price index is not a component of interest rates, so a lessee would use the incremental borrowing rate determined at the commencement date to remeasure the lease liability. Is that correct?

Issue 3: Partial Terminations

We are concerned that the approach to determining whether a lessee qualifies for the simplified modification guidance provided in the Proposed ASU is more difficult than it should be. The Board's decision to require a lessee to include any termination payment in determining if the payments for the continuing leased assets are substantially the same as they were before the modification makes it more likely that a lessee will not qualify for the simplified approach. A negotiated termination payment will consider a number of factors, including, among others, the tax consequences to the lessor from the early return of the leased asset, the expected period that it will take to re-lease the returned asset, changes in the fair value of the underlying asset since the commencement of the lease and the expected rental rates the lessor can achieve for those assets. Leases of the same assets terminating at different times could result in the lessees making different termination payments based on those factors. In an economic downturn, a lessee may be required to make a larger payment to terminate a lease early. Depending on the total value of the assets subject to the original lease, that larger payment could lead to a conclusion that the proposed method is not appropriate if the portion of the lease terminated is a significant proportion to the total, even when the termination payment truly only relates to the assets for which the lease is terminated.

Further, a requirement to consider the impact that any consideration allocated to non-lease components could have on a conclusion that the payments for the continuing leased assets are substantially the same as they were before the partial termination (an impression based on the discussion in paragraph BC28

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rather than the wording of the proposed guidance) adds complexity to the accounting for little benefit that we have been able to identify.

We would prefer an approach that compares the present value of the remaining lease payments to the carrying amount of the lease liability relating to assets the lessee continues to use. Under this approach, the amount identified as the termination payment would not be allocated to the assets the lessee continues to use. If the present value of the remaining lease payments is significantly more or less than the carrying amount of the lease liability relating to assets the lessee will continue to use, the lease of the remaining assets has been modified and the simplified method would not apply. We believe lessees will be able to make this calculation without significant difficulties because in many instances they already will have allocated the payments under the lease to the separate lease components at the commencement of the lease. Under our proposed approach, the termination payment would be presumed to be related to the assets for which the lease is terminated. However, if the lease agreement has provisions outlining payments the lessee would be required to make on other events that result in a termination of the lease (for example, a casualty that results in the destruction of the asset), a termination payment that differs from the termination payment outlined in those other provisions would require the lessee to either:

(a) allocate a portion of the termination payment as consideration for the lease of the assets the lessee will continue to use (when the negotiated termination payment exceeds the payment that would be made in connection with the termination event described in the lease agreement) or

(b) allocate a portion of the consideration for the lease of the assets the lessee will continue to use to the termination payment (when the negotiated termination payment is less than the payment that would be made in connection with the termination event described in the lease agreement).

If the Board decides to retain the proposed guidance, we recommend adding an example illustrating how the guidance should be applied, particularly in a situation where it has allocated a portion of the consideration to non-lease components.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

NSchroeder

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