Proposed Accounting Standards Update on Leases

Overview
On May 16, 2013, the Financial Accounting Standards Board (FASB), jointly with the International Accounting Standards Board (IASB), issued for public comment its proposal to increase transparency and comparability among public and private companies and not-for-profit organizations that lease assets by recognizing assets and liabilities that arise from lease transactions on a lessee’s balance sheet.

The Boards took into account stakeholder feedback on the 2010 Exposure Draft on leases and through deliberations and numerous stakeholder meetings, panel discussions, webcasts, and in-person seminars agreed upon an approach to address the concerns that many stakeholders have with current operating lease accounting.

Proposed Accounting Standards Update, Leases (Topic 840), creates a new approach to lease accounting that would require assets and liabilities arising from leases to be recognized in the statement of financial position.

The proposed requirements would supersede IAS 17, Leases, (and related Interpretations) in International Financial Reporting Standards (IFRS) and the requirements in Topic 840, Leases, of the FASB Accounting Standards Codification®.

Stakeholders are asked to review and provide comments on the proposal by September 13, 2013.

Why Did the FASB Undertake the Leases Project?
Leasing is an important activity for many organizations—whether public or private companies, or not-for-profit organizations. It is a means of gaining access to assets, obtaining financing, and reducing an organization’s exposure to the risks of asset ownership. Many organizations lease assets such as real estate, airplanes, trucks, ships, and construction and manufacturing equipment. Because of the prevalence of leasing, it is important for users of financial statements to have a complete and understandable picture of an organization’s leasing activities.

The existing accounting models for leases require lessees and lessors to classify their leases as either capital leases or operating leases and to account for those leases differently. Some leases are classified as capital leases (for example, a lease of equipment for nearly all of its useful life), whereby the lessee would recognize lease assets and liabilities on the balance sheet. Other leases are classified as operating leases (for example, a lease of office space for 10 years), whereby the lessee would not recognize lease assets or lease liabilities on the balance sheet.

Those models have been criticized for failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leasing transactions.

When assets and liabilities for leases are not recognized on the balance sheet, most users of financial statements make adjustments to the financial statements (using disclosures and other available information) to estimate the effects of leases on a lessee’s financial statements.

As a result, there has been a widespread request from users of financial statements and other stakeholders to change the accounting guid-
anc so that lessees would be required to recognize assets and liabilities arising from leases.

In addition, the U.S. Securities and Exchange Commission (the SEC) issued a report on off-balance sheet activities in 2005 that recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting. A number of academic studies have made similar recommendations.

The FASB and the IASB issued the 2009 Discussion Paper and the 2010 Exposure Draft on leases which contained proposals to improve the financial reporting of lease contracts. After carefully considering feedback from stakeholders on the 2010 Exposure Draft and performing a significant amount of outreach with stakeholders, the FASB and the IASB are issuing a revised exposure draft.

What Are the Main Provisions Relating to the Lessee Model?
The core principle of the proposed requirements is that an organization should recognize assets and liabilities arising from a lease. This represents an improvement over existing leases standards, which do not require lease assets and lease liabilities to be recognized by many lessees.

In accordance with that principle, a lessee would recognize assets and liabilities for leases with a maximum possible term of more than 12 months. A lessee would recognize a right-of-use asset to make lease payments and a right-of-use asset representing its right to use the leased asset for the lease term.

The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee would depend primarily on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For practical purposes, this assessment would often depend on the nature of the underlying asset.

For most leases of assets other than property (for example, equipment, aircraft, cars, trucks), a lessee would do the following:

- Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments
- Recognize and present the interest on the lease liability separately from the amortization of the right-of-use asset.

For most leases of property (for example, land and/or a building or a part of a building), a lessee would do the following:

- Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments
- Recognize a single lease cost, combining the interest on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

The Boards also proposed disclosures that should enable investors and other users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

The Boards made changes to the proposals since the 2010 Exposure Draft in response to feedback from stakeholders that should reduce the
Examples of decisions the Boards made during rede-liberations that should reduce cost and complexity include:

- **Short-term leases**: The Boards tentatively decided that a preparer can elect not to apply the proposals to short-term leases (leases with a maximum lease term of 12 months or less).

- **Variable lease payments**: The Boards tentatively decided that variable lease payments not based on an index or rate (for example, lease payments based on percentage of sales) should not be included in the liability.

- **Lease renewals.Optional periods**: The Boards tentatively decided to raise the threshold for including optional periods in the liability.

- **Nonpublic organizations (FASB only)**: The Board tentatively decided that private companies and non-public not-for-profit organizations can elect to use a risk-free rate to discount the lease liability, and they are not required to disclose a roll-forward of the lease liability.

In addition, the Boards decided that it would be beneficial to consider lessee accounting at the same time they are developing proposals on revenue recognition. Consequently, the revised Exposure Draft proposes changes to both lessee accounting and lessor accounting.

Similar to the accounting for a lessee, the accounting for a lessor would also depend primarily on the degree of consumption of the leased asset. The criteria used by lessors to distinguish between the two types of leases are the same as the criteria used by lessees. For practical purposes, this assessment would often depend on the nature of the underlying asset.

For most leases of assets other than property (for example, equipment, aircraft, cars, trucks), a lessor would do the following:

- Derecognize the underlying asset and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset)

- Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term

- Recognize any profit relating to the lease at the commencement date

- Eliminate the special requirements for leveraged leases.
The Leases project is a converged effort between the FASB and the IASB.

For most leases of property (for example, land and/or a building or a part of a building), a lessor would apply an approach similar to existing operating lease accounting in which the lessor would do the following:

- Continue to recognize the underlying asset
- Recognize lease income over the lease term, typically on a straight-line basis.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

The FASB and the IASB have developed a set of converged proposals for accounting for leases. The Boards believe their existing standards for leases need improvement and have worked in a coordinated fashion with their staff to develop a converged, improved solution.

The revised exposure drafts for the FASB and IASB are nearly identical. The differences between the two proposals are primarily related to existing differences between U.S. generally accepted accounting principles (GAAP) and IFRS and decisions the FASB made related to nonpublic entities.

What Are the FASB’s Proposed Provisions for Nonpublic Organizations?

U.S. GAAP would permit a policy election to use a risk-free rate to discount the liability.

U.S. GAAP would permit an exemption from the liability balance reconciliation disclosure.

The IASB will consider whether, and if so how, to incorporate this requirement into their IFRS for Small and Medium-sized Entities at a later date.

When Would the Amendments Be Effective?

The Boards will set the effective date for the proposed requirements when they consider interested parties’ feedback on this revised Exposure Draft.

The Boards are aware that the proposals affect almost every reporting organization. Some of those organizations have many leases, and the proposed changes to accounting for leases are significant.

The Boards will consider these and other relevant factors when setting the effective date.

What Are the Next Steps in the Process?

Stakeholders are encouraged to review and provide feedback on the proposed Update by September 13, 2013.

Further information, including the revised Exposure Draft and press release, is available on the FASB website at www.fasb.org.