



Financial Accounting Standards Board

Leases – Project Update

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Jeff Wilks

FASB Academic Fellow



Disclaimer

The views expressed in this presentation are my own and do not represent positions of the Financial Accounting Standards Board.

Positions of the FASB are arrived at only after extensive deliberations and due process.



Topics

- Decisions reached by the FASB
- Joint project approach
- Timeline for the lease project
- International working group
- Alternative approaches (speculation)
- Questions and comments



Decisions Reached

- On July 19, 2006, the FASB added lease accounting to their agenda.
- The FASB agreed that this would be a joint project with the IASB.
- The initial due process document will be a preliminary views paper.
- A joint international working group will be formed to provide input to both Boards.



Reasons: Complexity

- FASB Statement No. 13 issued 1976
- Since then,
 - 9+ FASB amendments
 - 6+ FASB interpretations
 - 12+ FASB technical bulletins
 - EITF issues too numerous to count
- A very complex (and often rules-based) area of accounting!



Reasons: Int'l Convergence

- Leasing is a global business.
- Capital markets are also global.
- However, lease accounting standards differ across accounting jurisdictions.
- Reporting leases consistently across jurisdictions improves efficiency and understanding of capital markets.



Reasons: User Needs

- “All-or-nothing” approach may not communicate the resources and obligations arising from leases.
 - Analysts routinely capitalize operating leases.
 - The SEC staff formally recommended improvements to lease accounting as part of its June 2005 report to Congress on off-balance sheet arrangements.



Reasons: Other Standards

- Other current FASB projects have potentially significant issues for leases
 - Control (business combinations project)
 - Assets & liabilities (conceptual framework)
 - Measurement (conceptual framework, FVM)
 - Revenue recognition (revenue recognition project)
 - Non-financial liabilities (IAS 37)
 - Derecognition (financial instruments)



Overall Objective

- To comprehensively reconsider the guidance in FASB Statement No. 13, together with its subsequent amendments and interpretations,
- To insure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions in the financial statements.



Overall Objective

- What does this mean?
 - The FASB and the IASB have decided to take a “fresh look” at current leasing standards.
 - It is too early to speculate about the scope of the project or how the current model might change.



Joint Project Approach

- Project team composed of staff from both boards.
- Boards look at the same papers and deliberate the same issues.
- Boards hope to reach the same decisions.
- Decisions subjected to both U.S. and international due process.



Project Timeline

- Research (2006)
 - History of lease accounting models and bases
 - Current lease accounting standards
 - Criticisms of current standards and need for a revised approach
 - Conceptual analysis of the lessee's asset and liability (incl. tax and legal perspectives)
 - Appropriate measurement attribute for the lessee's asset and liability



Project Timeline

- Research (2006)
 - Recognition/measurement of the lessor's asset
 - More complex leases:
 - Rights and obligations arising from options to renew or terminate the lease
 - Residual value guarantees and similar arrangements
 - Contingent and variable rentals
 - Sale and leasebacks
 - Lessor accounting
 - Disclosures by lessees and lessors



Project Timeline

- Board deliberations (2007-2008)
- Preliminary views document issued for public comment (2008)
- Exposure draft for public comment (2009)



International Working Group

- The Boards are currently seeking nominations to join the joint international working group.
- Deadline for nominations is Sept. 30, 2006.

The role of the working group is to provide views and practical advice on the concepts, ideas, and proposals developed by the Boards and their staff.



International Working Group

- The composition of the WG will reflect the diversity and breadth of interest in this area.
 - Preparers of financial statements that are lessors of various asset types such as equipment, other property, and real estate
 - Preparers of financial statements that lease various asset types such as equipment, other property, and real estate
 - Knowledgeable investors, investment analysts, and other users of financial statements
 - Auditors of financial statements.



Alternative Approaches

- Risks and Rewards (current model)
- Asset and Liability (G4+1, financial components, property rights)
- Whole asset (full-finance)

***Remember, this is speculation at this point!
The Boards may or may not consider these approaches, and they may consider other approaches not listed here.***



Risks and Rewards Approach

- Uses FAS 13 criteria to identify those leases in which substantially all of the risks and rewards of ownership are transferred to the lessee.
 - Title transfer
 - Bargain purchase option
 - Lease term \geq 75 percent of useful life
 - PV of MLP \geq 90 percent of asset's FMV
- Two types of leases: Operating and Capital



Asset and Liability Approach

- Proposes that rights to property represent an asset that should be recognized.
- The lessee's promise to pay represents an obligation that should be recognized.
- Measures the value of the property rights at FMV, but not less than PV of MLP.
- Results in only one type of lease.
- May allow an exception for short-term or immaterial leases.



Whole Asset Approach

- Proposes that the leased item is the asset, and its full FMV should be recognized.
- Two liabilities are recorded,
 - PV of MLP (just as in asset-liability approach)
 - PV of Residual Value
- Interest expense much higher for whole-asset approach than for asset-liability approach.
- Amortization much lower for whole-asset approach than for asset-liability approach.



Whole Asset Approach

- Basically presumes that the lessee takes possession of the whole asset and finances the acquisition with nothing down.
- Relative to the asset-liability approach
 - Leads to higher recognized assets and liabilities.
 - Leads to lower amortization expense, and higher interest expense (when looking at short-term leases).



Basic Example

- \$100 million airplane (FMV)
- 3 year lease
- \$10.5 million annual payments in arrears
- 7.5% incremental borrowing rate
- \$90.3 million residual value



Asset-Liability vs. Whole-Asset

	Year 1		Year 3	
	Financial Components	Whole Asset	Financial Components	Whole Asset
Assets				
Cash	(10,500)	(10,500)	(31,500)	(31,500)
PPE	27,306	100,000	27,306	100,000
Less: Accumulated amortization	(9,102)	(3,231)	(27,306)	(9,692)
Net PPE	18,204	96,769	-	90,308
Total Assets	7,704	86,269	(31,500)	58,808
Liabilities & Shareholders' Equity				
Long-term debt, current	9,086	3,225	-	90,308
Long-term debt, excluding current	9,767	93,775	-	-
Retained earnings (ignoring taxes)	(11,150)	(10,731)	(31,500)	(31,500)
Total Liabilities & Shareholders' Eq	7,704	86,269	(31,500)	58,808



Asset-Liability vs. Whole-Asset

	Year 1		Year 3	
	Financial Components	Whole Asset	Financial Components	Whole Asset
Operating expenses:				
Depreciation and amortization	(9,102)	(3,231)	(9,102)	(3,231)
Operating income	(9,102)	(3,231)	(9,102)	(3,231)
Interest expense	(2,048)	(7,500)	(733)	(7,033)
Net income (ignoring taxes)	(11,150)	(10,731)	(9,834)	(10,264)



What is the Asset?

- Should the focus remain on
 - the leased item (whether substantially all the risks and rewards of owning it have been transferred), or
 - the right to use the leased item (along with any other rights such as renewal options)?
- The question is tied to the Boards' ongoing deliberations on the definitions of an asset and a liability.



Working Definitions

- Asset: An existing economic resource to which an entity has a present right or other privileged access.
- Liability: An existing economic burden for which an entity is presently obligated.



Lessor Accounting

- Has received much less attention
- Tied to revenue recognition project
- Questions:
 - What type of asset results?
 - Is it one or two assets?



Questions or Comments

Jeff Wilks
Financial Accounting Standards Board
401 Merritt 7, Norwalk, CT 06856

Phone: (203) 956-5353

Email: tjwilks@fasb.org