

AUGUST 17, 2010

Essential Elements



In Focus

The Exposure Draft proposes changes to simplify lease accounting standards and improve the quality and comparability of financial information for users. It results from a joint project of the FASB and the International Accounting Standards Board (IASB). The FASB and IASB Exposure Drafts are the same in all important respects.

- The core principle is that lease contracts give rise to assets and liabilities that should be reflected in the balance sheets of lessees and lessors. As such, calculated financial ratios (leverage ratios, for example) would be more complete and comparable.
- All lessees would use a single method of accounting for all leases. Balance sheets of lessees would include both assets representing the right to use the leased asset and liabilities arising from lease contracts at the present value of the expected lease payments.
- The accounting by a lessor would reflect its exposure to the risks or benefits of the underlying leased asset. A lessor that has transferred significant risks or benefits would recognize a gain or loss upon lease commencement. When the lessor retains significant risks or benefits in the leased asset, it would recognize income over the lease term.
- Users of financial statements would have more timely information about variable features such as renewal options and contingent rentals.
- A simplified approach would apply to short-term leases.
- The proposal does not change the current definition of a lease contract.

Exposure Draft: *Leases*

Why are the Boards proposing new standards?

Leasing is an important source of finance for many businesses. According to the *World Leasing Yearbook 2010*, leasing activity in 2008 amounted to \$640 billion. However, the assets and liabilities arising from many of those contracts are not shown in a lessee's balance sheet.

It is important that financial statements provide investors and other users of financial statements with a complete picture of a company's leasing activities. Current standards need improvement to provide that complete picture, as described below.

Improvement needed:	Proposed solution:
<p>Current standards have two lease categories: capital leases and operating leases. Because of the bright-line tests used in US GAAP to distinguish between an operating lease and a capital lease, small differences in terms of the lease arrangement affect whether lease assets and liabilities are reported on lessee balance sheets. This results in an understatement of assets and liabilities and allows for structuring opportunities for lessees to achieve a particular accounting outcome. Also, economically similar transactions may be accounted for in dramatically different ways, reducing comparability between entities.</p>	<p>Establishes one method of accounting by lessees that would recognize on company balance sheets the assets and liabilities arising from all lease contracts. A single method of accounting by lessees would produce more complete and comparable financial reporting. It reduces the opportunity to structure transactions to achieve a desired accounting outcome.</p>
<p>Financial statement users need to estimate the effect of operating leases on a company's leverage and other financial metrics.</p>	<p>The on-balance-sheet treatment of leases means users would no longer need to estimate the effects of operating leases when calculating financial metrics such as leverage ratios. Financial statements would provide users with a more accurate view of a company's liabilities and future cash flows.</p>

(continued)

Improvement needed: <i>(continued)</i>	Proposed solution: <i>(continued)</i>
<p>Although many leases include variable features (such as renewal options or contingent rentals), current standards generally account for those features on an outcome basis (as they occur), making it more difficult for users to assess the effects of those features on future cash flows.</p>	<p>The expected lease payments would include variable payments. Users would have more timely information about the effects of variable features such as renewal options and contingent rentals to better assess the effects on expected future cash flows.</p>

These proposed improvements would provide a more complete and accurate portrayal of an entity's financial position, providing relevant information to users about operating capacity, leverage, and return on capital.

Project Process Stage

In March 2009, the FASB and the IASB issued a Discussion Paper on Leases, and in August 2010, the FASB and the IASB issued the Exposure Draft. The Exposure Draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties.

Over the next several months, the Boards will undertake various other outreach activities (including

webcasts, fieldwork, meetings with investors, and public roundtable meetings) to discuss the proposal with a wide range of stakeholders.

The Board invites all interested parties to comment on the Exposure Draft. The Boards plan to carefully consider all feedback, redeliberate all significant aspects of the proposal, and issue final standards in 2011.

The proposed standards would apply to existing and new leases as of the effective date, which will be determined later in the project and will provide adequate lead time for implementation.

Comment Deadline

All are encouraged to comment on the proposal through December 15, 2010.

For more information about the project, please visit the FASB's website at www.fasb.org.

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