Lease Accounting

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- Views expressed are those of the speaker. The Board expresses its views in official publications.

Lease Accounting – New FASAB Project

August 2011, the Board approved a project plan to review existing federal lease accounting standards. The goal of the project on lease accounting is to address the needs of the federal community and to develop more comprehensive standards on federal leasing activities than the existing standards.

Lease Accounting – New FASAB Project

Why is a project on lease accounting needed?

- Distinctions between capital and operating leases criticized as not meaningful
- New lease accounting guidance being proposed by FASB/IASB
- Current FASAB guidance is not comprehensive enough to address all federal leasing activities

Lease Accounting – New FASAB Project

What questions / issues does the lease accounting project plan to address?

- How to apply new “asset” and “liability” definitions (SFFAC 5)
- Whether to consider the FASB/IASB revised leasing standards
- Effects of alignment between accounting standards and OMB Circular A-11
- Enhanced use leases
- Comprehensive lease accounting standards

Lease Accounting – Background (SFFAS 5 & 6)

- Current FASAB standards addressing leasing transactions include SFFAS 5 *Accounting for Liabilities of the Federal Government* [pars. 43 – 46] and SFFAS 6 *Accounting for Property, Plant, and Equipment* [pars. 20 & 29].
- These lease standards were originally developed from Financial Accounting Standards Board (FASB) lease standards effective at that time.

Lease Accounting – FASB/IASB Project

- FASB and IASB have undertaken a joint project on lease accounting
- The original exposure draft was released August of 2010
- The Boards have decided to re-expose the revised lease accounting proposals. The new exposure draft is expected to be released sometime during the second half of 2012.

Lease Accounting – Implementation Question

- **Question:** Once the new FASB/IASB lease standards are issued as final, should federal entities that present general purpose financial reports in conformance with SFFAS 34 follow those new FASB/IASB lease accounting standards?
- **Answer:** No. Issuance of the new FASB/IASB standards will not automatically change federal financial accounting standards.

Lease Accounting – (SFFAS 5)

Par 43. Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee. If, at its inception, a lease meets one or more of the following four criteria, the lease should be classified as a capital lease by the lessee:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property. If a lease does not meet at least one of the above criteria it should be classified as an operating lease.

Par 44. The amount to be recorded by the lessee as a liability under a capital lease is the present value of the rental and other minimum lease payments during the lease term, excluding that portion of the payments representing executory cost to be paid by the lessor.

Lease Accounting – (SFFAS 6)

- **Par 29**. The cost of general PP&E acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in the liability standard unless the net present value exceeds the fair value of the asset).

Lease Accounting – Project Objectives

The primary objectives of this project are to:

- Develop an approach to lease accounting that would ensure that all assets and liabilities [consistent with Statement of Federal Financial Accounting Concepts (SFFAC) 5 definitions] arising under lease contracts are recognized in the statement of financial position and related costs are recognized in the statement of net cost.
- Evaluate and revise as needed the current lease-related definitions and recognition guidance in SFFAS 5 and 6, including consideration of the advantages and disadvantages of applying the FASB/IASB lease standard in the federal environment.

Lease Accounting – Project Objectives (con't)

- Ensure that the standards to be developed fully address the various lease transactions/activities currently being used in the federal community (e.g. enhanced use leases).
- Consider the differences between lease accounting and the budgetary treatment of lease-purchases and leases of capital assets as outlined in Office of Management and Budget (OMB) Circular A-11.

Lease Accounting –
Overview of FASB/IASB Proposal

- The Boards are proposing a right-of-use model to all lease arrangements. Under that model, a lessee in an arrangement that is, or contains, a lease would recognize an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term.
- A lease is defined as a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

Lease Accounting –
Overview of FASB/IASB Proposal

Lessee Accounting

The Boards tentatively decided that lessees should apply a single accounting approach for all leases. This accounting approach would require a lessee to:

- Initially recognize a liability to make lease payments and a right-of-use asset, both measured at the present value of the lease payments.
- Subsequently measure the liability to make lease payments using the effective interest method.
- Amortize the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

Lease Accounting –
Overview of FASB/IASB Proposal

Lessor Accounting

The Boards discussed the receivable and residual approach and tentatively decided that for all lease contracts within the scope, a lessor should:

- Initially measure the right to receive lease payments at the present value of the lease payments, discounted using the rate the lessor charges the lessee, and subsequently measure at amortized cost applying an effective interest method.
- Initially measure the residual asset as an allocation of the carrying amount of the underlying asset. The initial measurement of the residual asset comprises two amounts: (a) the gross residual asset, measured at the present value of the estimated residual value at the end of the lease term discounted using the rate the lessor charges the lessee and (b) the deferred profit, measured as the difference between the gross residual asset and the allocation of the carrying amount of the underlying asset.
- Subsequently measure the gross residual asset by accreting to the estimated residual value at the end of the lease term using the rate the lessor charges the lessee. The lessor would not recognize any of the deferred profit in profit or loss until the residual asset is sold or re-leased.
- Present the gross residual asset and the deferred profit together as a net residual asset.

Lease Accounting –
Overview of GASB Lease Project

In April 2011 GASB added a research project on lease accounting to its agenda.

- The objective of the project is to reexamine issues associated with lease accounting, considering improvements to existing guidance. If the project is added to the GASB's current agenda, the research project will provide a basis for the GASB to consider whether operating leases meet the definitions of assets or liabilities.
- Part of the GASB's strategic plan is to evaluate the effectiveness and impact of existing standards that have been in effect for a sufficient length of time. The project would provide an opportunity for a fresh look at the existing guidance for any improvements not contemplated by the FASB/IASB project given the unique nature of governmental entities and the complexities of their leasing transactions.

Lease Accounting – Status of FASAB Project

- Task Force
- Agency Questionnaire
- Follow Progress of FASB/IASB Project
- Research on Federal Leasing Activities

Website and Contact Information

- General inquiries can be directed to fasab@fasab.gov
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  - Listserv
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