Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Fax: 203-849-9714

Testimony of

Kevin M. Stoklosa

Assistant Technical Director

Financial Accounting Standards Board

Before the

Subcommittee on Economic Development, Public Buildings & Emergency Management

Committee on Transportation and Infrastructure

March 24, 2010

Transparency in Accounting: Proposed Changes to Accounting for Leases

Introduction

Madame Chairman, Mr. Dias-Balart and members of the Subcommittee, my name is Kevin Stoklosa, Assistant Technical Director, of the Financial Accounting Standards Board ("FASB" or "Board"). I have prepared remarks that I would like to present to you today and I would respectfully request that the full text of my testimony be entered into the public record of today's hearing.

The Subcommittee has identified the challenge of maintaining a dwindling Federal Building Fund. As the Subcommittee considers ways in which to address these challenges, I would like to focus my remarks on the FASB's Statement No 13, Accounting for Leases, and how the expected revisions to this standard could impact the Federal Building Fund.

The FASB

The FASB is an independent private-sector organization. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the U.S. economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[1] is a critical aspect of the standard-setting process and fundamental to our mission, because our work is technical in nature and designed to provide preparers with the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor.

[1] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).

While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the U.S. economy.

The FASB's authority with respect to public enterprises comes from the U.S. Securities and Exchange Commission ("SEC" or "Commission"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 35 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC issued a Policy Statement in 2003 reaffirming this longstanding relationship.[2]

The Policy Statement, consistent with the language and intent of the Act,[3] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[4]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"), is responsible for maintaining active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board ("PCAOB"), and ultimately the SEC.

---

[2]Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003).
[3]Sections 108-109; the legislative history of the Act is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.
[4]Page 5 of 8.

Accounting Standard Setting Process

Because the actions of the FASB affect so many organizations, its decision-making process must be fair, open and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

In setting our standards, the FASB gives priority to the needs of investors because, in our view, the primary reason for developing high-quality accounting and external financial reporting standards is to enhance the efficiency of the capital markets by giving potential investors the information to confidently make lending and investing decisions. We also give careful consideration to the costs and benefits to companies that prepare the accounting information as well as the costs imposed on auditors, regulators, and the rest of society. In our view, these costs are important but secondary criteria for setting external financial reporting policy.

As significant reporting issues arise, the Board endeavors to understand those issues and to identify the reasons why they arose. Once the Board understands the underlying issues, it is able to assess whether there are potential accounting standard-setting matters that may need to be addressed.

Lease Accounting

The primary impetus for the FASB's current joint leasing project with the International Accounting standards Board (IASB) is the SEC's report from June, 2005 entitled "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, www.sec.gov/news/studies/soxoffbalancerpt.pdf.

This SEC report highlights several ways to improve transparency in financial reporting was submitted to the President of the United States, the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

In addition, the SEC report included several standard-setting recommendations that would help further these initiatives including reconsideration of the accounting guidance for leases, noting that current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet.

As a result of the 2005 SEC report, the FASB and IASB are tackling this leasing accounting challenge and issued a "preliminary view" document in March 2009 presenting our early ideas about ways to improve FASB statement number 13 and also soliciting comment from all affected constituents. An executive summary of this document is included in my testimony and the entire document is available at http://www.fasb.org/draft/DP_Leases.pdf

Today, lease accounting standards require lessees to classify their lease contracts as either finance (capital) leases or operating leases. Finance leases are defined as those leases that transfer to the lessee substantially all the risks and rewards incidental to ownership of the leased asset. All other leases are deemed operating leases. Detailed rules and "bright-line" tests are used to differentiate between when a finance lease would be used versus an operating lease.

Leases classified as finance leases are treated as similar to a purchase of the underlying asset such as purchasing office furniture or a copy machine. Consequently, the lessee recognizes in its statement of financial position the leased item and an obligation to pay rentals. The lessee depreciates the leased item and apportions lease payments between a finance charge and a reduction of the outstanding liability. The lessor treats the leased item as a sale and removes it from its balance sheet.

For leases classified as operating leases, no similar assets or liabilities are recognized by the lessee and the lessor does not remove the asset from its balance sheet. Other than rental express being reported in the income statement each reporting period, operating lease accounting lacks transparency around the assets and liabilities inherent in the lease.

Given this lack of transparency, the existing lease accounting model has been criticized by users of financial statements for failing to meet their needs. Preparers and auditors also have criticized the existing lease accounting model for its complexity. In particular, the detailed rules and "bright-line" tests for differentiating finance leases versus operating leases have proved difficult to implement.

After much analysis, the FASB and the IASB are developing a new approach to accounting for leases that would require all leases to be accounted for similarly.
Rather than treating some lease contracts like a purchase of the leased item (finance leases) and others as executory contracts (operating leases), the new proposed approach would treat all lease contracts as the acquisition of a right-to-use the leased item for the lease term.

The lessee would recognize the following:

- an asset representing its right to use the leased item for the lease term (the right-of-use asset); and
- a liability for its obligation to pay rentals.

For lessors, the Boards decided to adopt a performance obligation approach. Under that approach, a lessor would recognize:

- an asset representing its right to receive rental payments (a lease receivable)
- A liability representing its performance obligation under the lease (its obligation to permit the lessee to use one of its assets—i.e., the leased item)\

The lessor would recognize revenue as the performance obligation is satisfied over the lease term.

This new approach to lease accounting would also be applied to sale-leaseback type transactions whereby the owner of an asset such as a building sells the building to a third party and leases it back for an agreed upon period of time. In those situations, the seller would derecognize or remove the building from its balance sheet, record any profit associated with the sale, and then recognize an asset representing its right to use the leased building for the lease term and a liability for its obligation to pay rentals.

The FASB and IASB have noted that this new approach to lease accounting would address many of the criticisms of the existing standards.

Conclusion

The FASB recognizes the challenges facing this Subcommittee as it works to maintain the Federal Building Fund. The fundamental issue that relates to the transparency of information available to investors to better enable them to understand and true financial health of an organization is the reason why the Board has undertaken this project to improve lease account.

Madame Chairman that concludes my prepared remarks. I would like to thank you and the Subcommittee for the opportunity to testify this afternoon. I would be happy to answer any questions.

EXECUTIVE SUMMARY OF

FASB PRELIMINARY VIEWS DOCUMENT

LEASING

Invitation to comment and summary

Introduction

IN1 This discussion paper presents the preliminary views of the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on significant components of an accounting model for lessees. It also includes a discussion of some of the issues that will need to be addressed in any new standard on lessor accounting.

IN2 It is designed to gather information to assist the boards in developing a new standard on lease accounting.

Summary of the discussion paper

IN3 The following paragraphs summarise the content of this discussion paper and the preliminary views reached by the boards.

IN4 Chapter 1 explains why the boards decided to add a project on lease accounting to their agendas and describes the history of the lease accounting project.

IN5 The boards' proposed approach to scope is discussed in chapter 2. The boards tentatively decided that the scope of the proposed new standard should be based on the scope of their existing standards on lease accounting.

IN6 Chapter 3 describes the overall approach to lessee accounting proposed by the boards. The boards tentatively decided that in a simple lease the lessee obtains a right to use the leased item that meets the definition of an asset and that the related obligation to pay rentals meets the definition of a liability. Consequently, the boards tentatively decided to adopt a new accounting model for leases that results in the lessee recognising:

(a) an asset representing its right to use the leased item for the lease term (the 'right-of-use' asset)
(b) a liability for its obligation to pay rentals.

IN7 The boards also tentatively decided not to recognise the components of a lease contract separately (such as options to renew, purchase options, contingent rental arrangements or residual value guarantees). Instead, the boards tentatively decided that the lessee should recognise:

(a) a single right-of-use asset that includes rights acquired under options; and
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

IN8 Chapters 4 and 5 describe the boards' preliminary views on measurement of the lessee's right-of-use asset and its obligation to pay rentals arising in a simple lease.

IN9 The boards tentatively decided that the lessee's obligation to pay rentals should be measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate. Subsequent measurement would be on an amortised cost basis.

IN10 The boards also tentatively decided that the lessee's right-of-use asset should be measured initially at cost. Cost would be equal to the present value of the lease payments discounted using the lessee's incremental borrowing rate. The boards tentatively decided that a lessee should amortise the right-of-use asset over the shorter of the lease term and the economic life of the leased item.

IN11 Chapter 6 discusses how to account for leases that include options that grant the lessee the right to extend the lease, terminate the lease or purchase the leased item.

IN12 The boards tentatively decided that the assets and liabilities recognised by the lessee should be based on the most likely lease term. For example, in a 10-year lease that includes an option to extend for an additional five years, the lessee must decide whether the lease term is 10 years or 15 years. Measurement of the obligation to pay rentals and the right-of-use asset would be consistent with the most likely lease term.

IN13 The boards tentatively decided to require the lease term to be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN14 The boards tentatively decided that the accounting requirements for purchase options should be the same as for options to extend or terminate the lease. Thus:

(a) in recognising the obligation to pay rentals, the lessee must decide whether it is likely that an option to purchase will be exercised. If the lessee decides that the option to purchase is likely to be exercised, the obligation to pay rentals will include the exercise price of the option. This assessment will be based on the lessee's determination of the most likely outcome.
(b) whether a purchase option will be exercised will be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN15 Chapter 7 describes the boards' preliminary views on the recognition and measurement of leases that include contingent rental arrangements and residual value guarantees. The boards tentatively decided that the lessee's obligation to pay rentals should reflect the lessee's obligation to make payments under contingent rental arrangements.

IN16 The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The obligation to pay rentals should be remeasured at each reporting date to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN17 The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payments. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. The FASB also tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised in profit or loss. For other forms of contingent rentals the obligation to pay rentals should also be remeasured at each reporting date to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from these reassessments should also be recognised in profit or loss.

IN18 The boards tentatively decided not to recognise residual value guarantees separately from the obligation to pay rentals. The boards also tentatively decided that leases that include residual value guarantees should be measured on the same basis as leases that include contingent rental arrangements.

IN19 Chapter 8 describes the boards' preliminary views on how the assets, liabilities, expenses and cash flows arising from lease contracts should be presented in the financial statements. Those preliminary views are based on existing presentation requirements. The effect that proposed changes to financial statement presentation could have on the boards' preliminary views is discussed at the end of chapter 8.

IN20 Chapter 9 provides a brief overview of a number of lessee accounting issues the boards have not yet discussed in sufficient detail to reach a preliminary view. The boards will need to resolve those issues before publishing an exposure draft.

IN21 Chapter 10 describes some of the issues that will need to be addressed in any new lessor accounting standard.

The leases working group

IN22 In 2006 the boards set up a joint lease accounting working group that includes users, preparers and auditors of both lessees' and lessors' financial statements. The group met in February 2007 and provided valuable comments on the early proposals for lease accounting. Since then, members of the working group have continued to contribute to the project informally and at a meeting in October 2008 commented on an early draft of this discussion paper.

Next steps

IN23 In April 2008 the boards announced their intention to produce a revised standard for lessees by mid-2011. Consequently, after publishing this discussion paper, the boards intend to work on an exposure draft of a proposed new standard for lessees. The boards will decide on the timing of any new standard for lessors after publishing this discussion paper. In developing an exposure draft, the boards will review the responses to this paper and decide whether to modify or confirm their preliminary views. The boards will pay particular attention to the need for users of financial statements to receive relevant and reliable information at a reasonable cost to preparers.

IN24 As discussed in subsequent chapters, the boards reached different preliminary views in some areas. The boards will resolve those differences in the light of comments received on this discussion paper.

IN25 The boards expect the work on lease accounting to proceed in parallel with other projects that may provide useful inputs to this project (including those on the conceptual framework, derecognition, revenue recognition, financial statement presentation and financial instruments) but they will not necessarily wait for the outcome of those projects. In addition, the work on lease accounting may provide useful input to other projects.

Invitation to comment

IN26 The boards invite comments on all matters in this paper. Chapters 2 - 10 include questions for respondents. Appendix A lists all the questions. Comments are most helpful if they:

(a) respond to the questions as stated
(b) indicate the specific paragraph or paragraphs to which the comments relate
(c) contain a clear rationale
(d) describe any alternative the boards should consider.

IN27 Respondents need not comment on all the questions and are encouraged to comment on any additional issues.

IN28 The boards will consider all comments that are received in writing by July 17, 2009.