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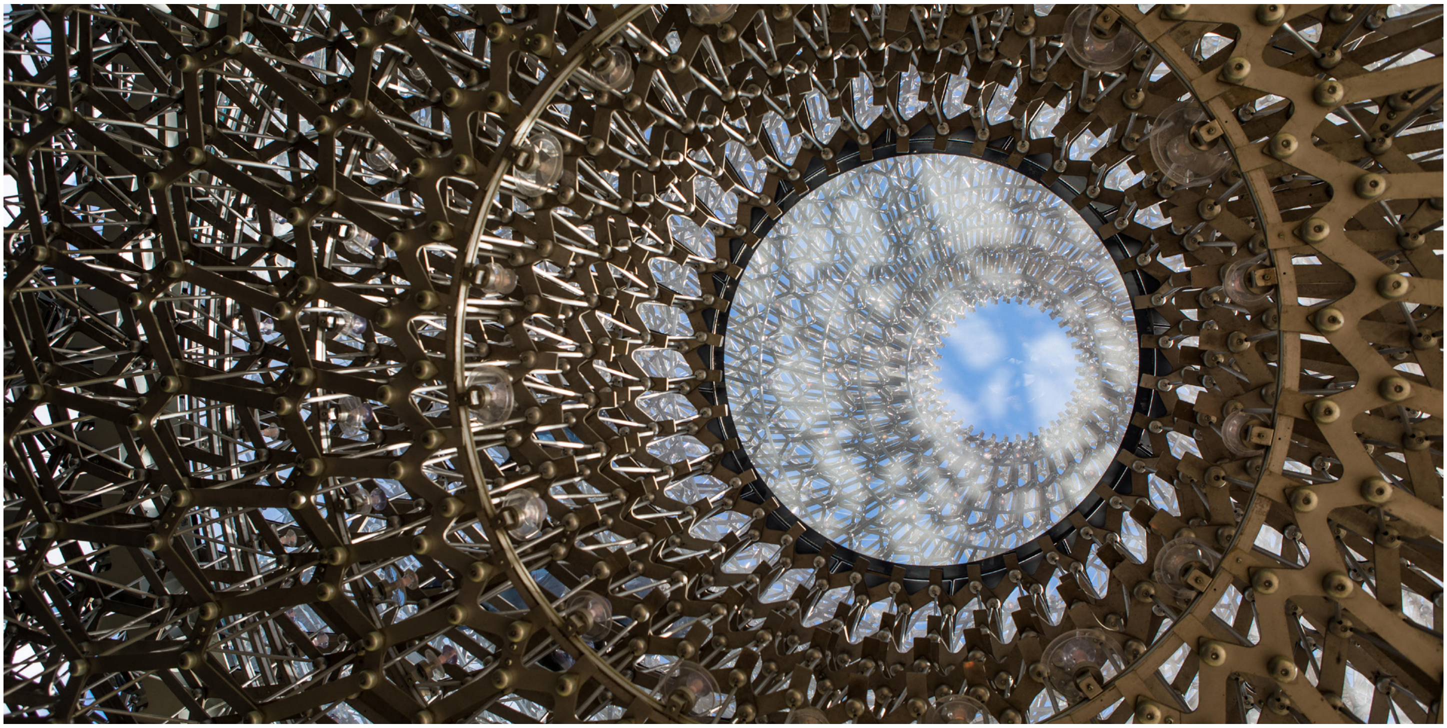

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FASB Decks Lessors' Halls With "Lesser" Requirements

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As entities prepare to adopt ASC 842,[1] lessors have raised certain implementation concerns. To assist lessors with implementation of the new leasing standard without compromising information provided to financial statement users, the Board issued ASU 2018-20[2] on December 10, 2018. The ASU includes amendments related to the following items:

- *Item 1* — Sales taxes and other similar taxes collected from lessees.
- *Item 2* — Lessor costs paid directly by a lessee.
- *Item 3* — Recognition of variable payments for contracts with lease and nonlease components.

This *Heads Up* summarizes the amendments made by ASU 2018-20 and provides key insights into how lessors are expected to apply these amendments.

[1] For titles of *FASB Accounting Standards Codification (ASC)* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[2] FASB Accounting Standards Update (ASU) No. 2018-20, *Narrow-Scope Improvements for Lessors*.

Connecting the Dots

Other Relevant ASUs and Proposed ASUs for Lessors

In November 2018, the FASB issued ASU 2018-19[3] to clarify certain aspects of the new current expected credit losses (CECL) impairment model in ASU 2016-13.[4] ASU 2018-19 points out that operating lease receivables are within the scope of ASC 842 rather than ASC 326. That is, an entity would apply ASC 842 rather than ASC 326-20 to account for changes in the collectibility assessment for operating leases. When applying ASC 842, an entity would recognize changes in the collectibility assessment for an operating lease as an adjustment to lease income in accordance with ASC 842-30-25-13 rather than recognizing bad debt expense.[5]

On December 4, 2018,[6] the Board tentatively decided to add to its agenda a project on Codification improvements for lessors. Specifically, the Board decided to amend the guidance in ASC 842 on (1) determination of the fair value of the underlying asset by lessors that are not manufacturers or dealers and (2) presentation in the statement of cash flows for entities within the scope of ASC 942. A proposed ASU related to these amendments is expected to be issued in late December or early January 2019.

For more information about ASC 842, see Deloitte's *A Roadmap to Applying the New Leasing Standard*, which serves as a comprehensive guide to the new leasing guidance.

Item 1: Sales Taxes and Other Similar Taxes Collected From Lessees

Under ASC 606, as amended by ASU 2016-12,[7] entities can elect an accounting policy of presenting sales taxes collected from customers on a net basis. Specifically, ASC 606-10-32-2A states, in part:

> An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes).

As issued, ASU 2016-02[8] did not provide lessors with a similar practical expedient for sales taxes collected from lessees. Feedback from stakeholders cited operational challenges with applying the new leasing guidance without such an expedient. Stakeholders noted that although lessors are not within the scope of ASC 606, they are performing a revenue-generating activity in a manner similar to a service accounted for under ASC 606. Therefore, these stakeholders requested that the FASB provide a similar practical expedient under which lessors could elect to present sales taxes collected from lessees on a net basis.

Accordingly, ASU 2018-20 offers lessors an accounting policy election under which they can exclude from lease revenue sales taxes and other similar taxes assessed by a governmental authority and collected by the lessor from a lessee. Lessors making this accounting policy election must disclose that they have done so in addition to providing the disclosures required by ASC 235-10-50-1 through 50-6.

[3] FASB Accounting Standards Update No. 2018-19, *Codification Improvements to Topic 326,* Financial Instruments — Credit Losses.
[4] FASB Accounting Standards Update No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. See Deloitte's June 17, 2016, *Heads Up* for more information about this new CECL model, which is based on expected losses rather than incurred losses.
[5] See Deloitte's June 2018 *TRG Snapshot* for more information about billed operating lease receivables.
[6] See Deloitte's December 7, 2018, journal entry for more information about the tentative decisions reached by the FASB at its December 4, 2018, meeting.
[7] FASB Accounting Standards Update No. 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*.
[8] FASB Accounting Standards Update No. 2016-02, *Leases*.

Connecting the Dots

The EITF addressed a similar topic in Issue 06-3,[9] which formed the basis of the guidance on the topic in ASC 606. Therefore, we believe that this guidance is important to understanding the basis for the scope of the accounting policy election under ASC 842-10-15-39A. Issue 06-3 indicates that its scope includes all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer. However, the scope does not include taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process. Similarly, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset are outside the scope of the accounting policy election under ASC 842-10-15-39A.

Moreover, during the deliberation of ASU 2018-20, stakeholders requested that the scope of this election be expanded to include property taxes but the FASB did not grant this request. That is, property taxes should not be considered to be within the narrow scope of this election; rather, an entity should consider property taxes when applying the guidance in ASC 842-10-15-40A, as discussed in Item 2 below.

We expect that entities will often align their accounting policy elections under ASC 606-10-32-2A with those under ASC 842-10-15-39A; however, we note that such consistency is not required.

Item 2: Lessor Costs Paid Directly by a Lessee

A lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party on behalf of the lessor or as a reimbursement to the lessor, does not result in the transfer of a good or service to the lessee separately from the right to use the underlying asset. ASU 2016-02, as initially issued, required a lessor to report those amounts, regardless of the payor, as revenue and expenses.

Under ASC 606, an entity must evaluate whether it is acting as the principal or the agent in the transaction to determine whether revenue should be presented on a gross or net basis. However, after the issuance of the new revenue standard, stakeholders raised questions about whether an entity should be required to estimate gross revenue when it is acting as the principal but there is uncertainty in the transaction price that is not expected to ultimately be resolved. As a result, when the FASB issued amendments to the principal-versus-agent guidance in ASU 2016-08,[10] it specifically addressed this question in paragraph BC38(c) of that ASU:

> The determination of whether revenue may be estimated or not is based on an assessment of the transaction price guidance in Section 606-10-32 on measurement (such as, the amount of consideration which the entity expects to be entitled to for transferring promised goods or services to a customer and the constraint on variable consideration). The guidance on variable consideration is instructive as to whether amounts should be recognized as revenue. A key tenet of variable consideration is that at some point the uncertainty in the transaction price ultimately will be resolved. When the uncertainty is not expected to ultimately be resolved, the guidance indicates that the difference between the amount to which the entity is entitled from the intermediary and the amount charged by the intermediary to the end customer is not variable consideration and, therefore, is not part of the entity's transaction price.

In light of the guidance in the Background Information and Basis for Conclusions of ASU 2016-08, some lessor stakeholders requested that the FASB provide a similar accounting policy election under which lessors would not be required to recognize lease revenue (and the corresponding expense) for certain costs that are considered lessor costs under ASC 842.

[9] EITF Issue No. 06-3, "How Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)."

[10] FASB Accounting Standards Update No. 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net).*

Accordingly, ASU 2018-20 addresses stakeholder concerns about the challenges related to determining costs paid by lessees directly to third parties on behalf of lessors by requiring lessors to exclude such costs from variable payments and thus from lease revenue. Lessor costs are not a component in the contract because they are neither lease components nor nonlease components (e.g., services). Some common examples of lessor costs include property taxes and insurance in a real estate lease.

The amendments in ASU 2018-20 also clarify that lessor costs that are paid directly to a third party by the lessor and then reimbursed by the lessee *must* be accounted for as variable payments. Paragraph BC28 of ASU 2018-20 notes that "[a]lthough the economics between Lessee-Paid and Lessee-Reimbursed are similar in that both may be costs of the lessor, the Board highlighted that all Lessee-Reimbursed costs are known amounts to the lessor and concluded that those costs should be accounted for as lessor costs."

Example

Lessee enters into a lease with Lessor for a yacht. According to the terms of the lease, Lessee pays maintenance, insurance, and property taxes directly to a third party. Lessor should consider the charges as follows:

- Insurance and property taxes are lessor costs (i.e., noncomponents) paid directly by the lessee; thus, Lessor *should not* report revenue or corresponding expense (i.e., should report on a net basis).
- Maintenance is a nonlease component and therefore not a lessor cost; thus, Lessor *should* report revenue and corresponding expense (i.e., should report on a gross basis).

Note that if Lessee reimbursed Lessor and Lessor paid a third party, the insurance and property taxes would also be reported on a gross basis.

Connecting the Dots

Item 1, as described above, is an accounting policy election that allows a lessor not to evaluate whether sales taxes and other similar taxes collected from a lessee represent lessor costs. However, the amendment related to Item 2 is a requirement. Further, the amendment distinguishes between the accounting for lessor costs that are paid directly by a lessee and the accounting for costs reimbursed by a lessee. When costs are reimbursed by a lessee and are not a component in the contract, a lessor will still need to determine whether a cost is a lessor cost (rather than a lessee cost). The amendments provide greater relief to lessors when the lessee directly pays such costs, because the accounting is the same irrespective of whether the costs are lessee or lessor costs.

Item 3: Recognition of Variable Payments for Contracts With Lease and Nonlease Components

ASU 2016-02 initially required lessors to recognize variable payments "in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur," regardless of whether the variable payment is related to the lease or nonlease component in the contract.

Stakeholders observed that the guidance, as originally issued, may lead a lessor to recognize as revenue a variable payment related to a nonlease component before control of the nonlease component is transferred to the customer. That is, as issued, ASC 842-10-15-40, read literally, implied that as soon as an uncertainty that created variability in the consideration is resolved, that amount should be recognized as revenue regardless of whether the item to which it is related has been delivered to the customer-lessee.

To clarify the Board's intent, ASU 2018-20 amended ASC 842 to require a lessor to allocate (rather than recognize) certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component would be "recognized as income in profit or loss in accordance with Topic 842, while the amount of variable payments allocated to nonlease components [would] be recognized in accordance with other Topics, such as Topic 606."

Example

Landlord enters into a five-year arrangement with Retailer to lease a retail space in a mall. Monthly payments are based on a variable structure, with a guaranteed minimum, as follows:

- Four percent of monthly retail sales revenues from January through June of each year.
- Two percent of monthly retail sales revenues from July through December of each year.
- Minimum amount due each month is $20,000.

Each monthly payment is compensation for the right to use the retail space (including reimbursement of associated property taxes and insurance), common-area maintenance (CAM), and an annual report. Landlord will provide the report on December 31 of each year. The report will include various statistical metrics and analyses (e.g., customer foot traffic, customer buying habits, video tracking data).

Landlord identifies three components in the contract:

- A lease component for the right to use the retail space.
- A nonlease component for the CAM.
- A nonlease component for the annual report that is a performance obligation distinct from the CAM services.

Landlord determines that, in accordance with ASC 606, the annual report (a nonlease component) is a performance obligation satisfied at a point in time and that control is transferred to Retailer upon delivery of the report on December 31. Accordingly, any variable payments received during the year and attributable to the annual report for the nonlease component should be deferred and recognized as revenue when the report is delivered and control is transferred at a point in time (i.e., at the end of each year). This conclusion is true regardless of whether the lessor has elected the practical expedient related to combining lease and nonlease components. This is because the nonlease component for the annual report would not meet the scope criteria for combination since its pattern of transfer (at a point in time) is not the same as the pattern of transfer of the lease component (over time provided that the lease component is an operating lease).

Effective Date and Transition

If an entity has not yet adopted ASU 2016-02 on the date of issuance of ASU 2018-20 (i.e., December 10, 2018), the effective date of ASU 2018-20 is aligned with that of ASU 2016-02. That is, the effective date is as follows:

- *Public entities* — Fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
- *All other entities* — Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In addition, such an entity should consistently apply the amendments to all new and existing leases and apply the same transition method elected for ASU 2016-02.

If an entity has already adopted ASU 2016-02 on the date of issuance of ASU 2018-20 (i.e., December 10, 2018), the entity may adopt ASU 2018-20 in a manner consistent with its adoption of ASU 2016-02 (i.e., its adoption would be consistent with the bullets above). Alternatively, an entity may elect to apply ASU 2018-20 as of either (1) the first reporting period (interim or annual) ending after the issuance of the ASU or (2) the first reporting period (interim or annual) beginning after the issuance of the ASU. In addition, an entity that has already adopted ASU 2016-02 on the date of issuance of ASU 2018-20 could elect to apply ASU 2018-20 to all new and existing leases either (1) prospectively or (2) retrospectively to all prior periods beginning with the fiscal years in which ASC 842 was initially applied.

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