New Developments Summary

Lessor narrow-scope improvements

ASU 2018-20 provides relief for lessors from certain requirements in ASC 842

Summary

The FASB recently issued ASU 2018-20, *Leases (Topic 842): Narrow Scope Improvements for Lessors*, to simplify how lessors implement the new leasing guidance in ASC 842, *Leases*.

ASU 2018-20 amends the guidance in ASC 842 as follows:

- *Sales taxes and other similar taxes collected from lessees* – Lessors may elect to account for sales and other similar taxes collected from lessees as lessee costs and to exclude them from the consideration in the contract and from variable payments not included in the consideration in the contract. This accounting policy election applies to all existing and new leases. Lessors that choose this accounting policy election are required to provide certain additional disclosures.
- *Certain lessor costs* – Lessors should exclude from variable payments, and therefore from revenue, all costs paid by lessees directly to third parties. However if costs are paid by a lessor directly to a third party and reimbursed by a lessee, the lessor should account for the reimbursement by the lessee as variable payments and recognize them as revenue.
- *Recognition of variable payments for contracts with lease and nonlease components* – Lessors should allocate certain variable payments to lease and nonlease components when the facts and circumstances that trigger the variable payments occur. The lessor should then recognize the variable payments allocated to the lease components as income in accordance with ASC 842, and the variable payments allocated to nonlease components in accordance with other Codification guidance, such as ASC 606, *Revenue from Contracts with Customers*.

An entity that has not yet adopted ASC 842 should apply the amendments in ASU 2018-20 when it adopts the new leasing standard.

Entities that have already adopted ASC 842 should apply the amendments in ASU 2018-20 at the original effective date for ASC 842. Alternatively, these entities may apply the amendments either in the first reporting period ending after December 10, 2018 or in the first reporting period beginning after December 10, 2018.

Entities that have already adopted ASC 842 may apply the amendments either prospectively or retrospectively to all prior periods beginning with the fiscal year in which the entity initially adopts ASC 842. The amendments must be applied to all new and existing leases.

Contents

A. Sales taxes and other similar taxes collected from lessees

ASC 842 requires a lessor to analyze sales and other taxes on a jurisdiction-by-jurisdiction basis to determine if the lessor is the primary obligor as owner of the underlying leased asset, or if it collects those taxes from the lessee on behalf of a third party, in which case, the lessee is the primary obligor for the taxes.

If the lessee is the primary obligor, the tax collected and paid to the third party is not reported in the lessor's income statement. On the other hand, if the lessor is the primary obligor, the revenue for tax collected, and the expense for tax paid, should be separately presented in the lessor's income statement.

Some lessors found this analysis to be time consuming and overly complex and, therefore, requested a practical expedient that would allow the lessor to exclude such taxes from the income statement without necessitating a principal versus agent analysis to identify the primary obligor, similar to an expedient offered in ASC 606-10-32-2A.

As a result, the practical expedient in ASU 2018-20 now allows a lessor to make an accounting policy election to exclude from its income statement taxes imposed on leasing revenue transactions by a government agency that are collected by the lessor from the lessee. Taxes within the scope of this election include sales tax, use tax, value-added tax, and some excise taxes. Taxes outside the scope of this election are taxes assessed on a lessor's total gross receipts, as well as taxes assessed on the lessor as the owner of the underlying asset, such as property taxes. However, property taxes and other costs incurred by the lessor as the owner of an underlying asset are subject to a separate amendment in ASU 2018-20, as discussed in Section B.

A lessor choosing this accounting policy should exclude all taxes collected from the lessee that fall within the scope of this election from both consideration in the contract and variable payments that are not included in consideration in the contract. A lessor must disclose its accounting policy election and present the accounting policy disclosures that are required in ASC 235, *Notes to Financial Statements*.

ASC 842-10-15-39A

A lessor may make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee (for example, sales, use, value added, and some excise taxes). Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset shall be excluded from the scope of this election. A lessor that makes this election shall exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes within the scope of the election and shall comply with the disclosure requirements in paragraph 842-30-50-14.

ASC 842-30-50-14

A lessor that makes the accounting policy election in paragraph 842-10-15-39A shall disclose its accounting policy election and comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

B. Certain lessor costs

ASC 842 requires a lessor to present payments that are made by a lessee to a third party for any costs related to owning the underlying asset separately as revenue and expense in its income statement, regardless of whether the lessee pays the third party directly on behalf of the lessor or reimburses the lessor for making payments to the third party. Such costs generally include property taxes and insurance. Some lessors found that if a lessee pays these costs directly to a third party, reporting the revenue and expense separately would be costly and complex, because these amounts might not be easily determinable.

The amendments in ASU 2018-20 differentiate between lessor costs that are paid directly to a third party and lessor costs paid to a third party that are reimbursed by the lessee. If a lessee pays a lessor's costs directly to a third party, the lessor should exclude those payments from variable payments and therefore from lease revenue. If a lessor pays costs to a third party and is reimbursed for those payments by the lessee, those costs should be accounted for as variable payments if they are excluded from consideration in the contract. ASU 2018-20 also updates Example 12, Case A, in ASC 842-10 to reflect the amendments to the guidance for a lessor's costs of owning an asset.

ASC 842-10-15-40A

The guidance in paragraph 842-10-15-40 notwithstanding, a lessor shall exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this requirement does not preclude a lessor from making the accounting policy election in paragraph 842-10-15-39A).

C. Recognition of certain variable payments

The guidance in ASC 842 requires lessors to recognize certain variable payments in the income statement in the period when they are incurred, regardless of whether the payments relate to lease or nonlease components. Some lessors raised concerns that the guidance could lead to recognizing revenue for nonlease components sooner under ASC 842 than under ASC 606, which could lead to different accounting for the same good or service based on whether or not it is included in a lease contract.

The amendments in ASU 2018-20 clarify that a lessor is required to allocate variable payments between lease and nonlease components when they are incurred. The lessor should recognize the portion of the payment allocated to the lease component under ASC 842, and the portion allocated to the nonlease component under other applicable accounting guidance, such as ASC 606. ASU 2018-20 also updates Example 14, Case A, in ASC 842-10 to reflect the amendments to the guidance for such costs.

ASC 842-10-15-40

If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall not recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).

D. Transition and effective date

An entity that has not yet adopted ASC 842 should apply the amendments in ASU 2018-20 when the new leasing standard is adopted.

Entities that have already adopted ASC 842 should apply the amendments in ASU 2018-20 at the original effective date for ASC 842. Alternatively, these entities may apply the amendments either in the first reporting period ending after December 10, 2018 or in the first reporting period beginning after December 10, 2018.

Entities that have already adopted ASC 842 may apply the amendments either prospectively or retrospectively to all prior periods beginning with the fiscal year in which the entity initially adopts ASC 842. The amendments apply to all new and existing leases.