Relief Approved for Lessors

With the effective date imminent for the new lease guidance for public entities,[1] the Financial Accounting Standards Board (FASB) recently approved relief for lessors. An Accounting Standards Update (ASU) is planned for issuance in mid-December 2018 that will address three lessor issues:

- Sales taxes collected from lessees – FASB developed a new accounting policy election to exclude certain taxes from lease revenue and expense
- Lessor costs paid by lessees – The amendments would require a lessor to exclude all lessor costs paid directly by a lessee to third parties on the lessor's behalf from the lease measurement
- Variable payments' allocation for contracts that contain lease and nonlease components – The amendments will clarify that lessors are required to allocate (rather than recognize) certain variable payments to a contract's lease and nonlease components when the uncertainty related to the variable payment changes

These amendments would apply to all new and existing leases.

Effective Dates Leases (Topic 842) ASU 2016-02	**Public Entities** Annual and interim periods beginning after December 15, 2018	**All Others** Annual periods beginning after December 15, 2019

Sales Taxes Collected from Lessees

Currently, Accounting Standards Codification (ASC) 842 requires lessors to analyze taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the lease's underlying asset or whether those taxes are collected by the lessor on behalf of third parties. When a tax is collected from a lessee on behalf of third parties, *i.e.*, lessor is acting as an agent, a lessor would exclude that amount from lease revenue. When the lessor is primarily obligated for payment of the tax, the lessor would include that amount gross—as a revenue and an expense.

Analyzing various taxes in multiple jurisdictions to determine net or gross presentation would be costly and complex. These amendments will provide an accounting policy election for lessors similar to one in ASC 606, *Revenue from Contracts with Customers*. If elected, a lessor would exclude certain taxes from the contract's consideration and variable payments not included in the contract's consideration. To be excluded, the taxes must be assessed by a governmental authority and be both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee, *e.g.*, 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 assets are out of scope for this election. Disclosure of the expedient is required, if elected.

Costs Paid by Lessees

Lessors incur a variety of costs related to a lease's underlying asset. Frequently, lessees are required to pay some of those expenses (usually property taxes or insurance costs), either as a direct payment to a third party or as a reimbursement to the lessor. However, because those payments do not transfer a good or service to the lessee

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[1] *A public entity is defined as any one of these:*
- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the SEC*

separately from the right to use the underlying asset, ASC 842 currently requires a lessor to report those amounts gross, as a revenue and an expense. This seems straightforward, but keeping track of these costs can be expensive and time-consuming. As written, ASC 842 would force lessors to estimate these costs, which may not provide financial statement users with meaningful information. This frequently happens because some of the costs are lessee-specific and may be unknown to the lessor. For example, a lessee may be required to insure its leased asset. The lessee may choose to insure both leased and nonleased assets under a comprehensive umbrella insurance policy with a single premium. Under this scenario, it would be unlikely for a lessee to disclose to the lessor the portion of a premium related to the leased asset. It also would be a challenge for a lessor to estimate the cost.

To provide relief, these amendments will **require** a lessor to exclude from variable payments lessor costs paid by a lessee directly to a third party.

Variable Payments for Contracts with Lease & Nonlease Components

The third issue addressed is more of a technical correction than additional relief. Currently, ASC 842 requires lessors to recognize certain variable payment amounts 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 payment partially relates to nonlease components. As written, this could result in a lessor recognizing revenue for a nonlease component in a different period than when control of the nonlease component is transferred under ASC 606. The amendments will clarify that after any uncertainty is resolved, the variable payments are first allocated between lease and nonlease components under ASC 842, and then other relevant guidance is applied for recognizing amounts allocated to the nonlease component.

Effective Date & Transition

For entities that have not yet adopted ASU 2016-02, the transition and effective date guidance is the same as ASU 2016-02.

Because the release date of this ASU is so close to the effective date of the new lease guidance, FASB has provided special transition terms for early adopters. While the effective date will be the same as ASU 2016-02, early adopters can reflect the amendments either in the first reporting period ending after the ASU's issuance or in the first reporting period following the ASU's issuance. Prospective or retrospective application is permitted for entities that have already adopted ASU 2016-02.

Conclusion

The adoption of ASC 842 will be complex and likely will require a significant time commitment to correctly implement the new guidance. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance in complying with the new leases standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this issue. Visit our website to learn more.

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