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FASB FLASH REPORT

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FASB Issues Targeted Improvements to Leases Standard

The FASB issued ASU 2018-11 [1] to reduce costs for entities in adopting the new leases standard and to ease the application of the separation and allocation guidance for lessors. The new ASU is available **here**, and has effective dates and transition aligning with an entity's adoption of ASU 2016-02[2], except for entities that early adopted Topic 842, for which specific effective date and transition requirements apply.

BACKGROUND

In February 2016, the FASB issued ASU 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions. The new ASU includes a new (and optional) transition method whereby an entity can initially apply Topic 842 at its adoption date (for example January 1, 2019 for a calendar year-end public company) rather than at the beginning of the earliest period presented (for example January 1, 2017 for a calendar year-end public company). It also gives lessors a choice to not separate nonlease components from the associated lease component if certain conditions are met.

1 *Leases (Topic 842): Targeted Improvements*

2 *Leases (Topic 842)*

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MAIN PROVISIONS

Transition Relief

ASU 2016-02 initially provided a single transition method with which to adopt the new leases guidance: the modified retrospective transition method. Under that transition method, entities apply Topic 842 retrospectively to each prior reporting period presented including the new and enhanced Topic 842 disclosure requirements. Applying the new standard to prior periods can be an arduous and time-consuming task, and one which includes incremental efforts, such as calculating the balance sheet impact related to operating leases that were effective during those periods but which expired prior to the effective date of the new standard. As such, stakeholders questioned the benefits of this transition method compared to the costs to comply with it.

The FASB agreed with stakeholder feedback and decided to provide a new (and optional) transition method. Under the new transition method in ASU 2018-11, entities can initially apply the new leases guidance at the adoption date (rather than at the beginning of the earliest period presented) and recognize a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption (for example, January 1, 2019 for a calendar year-end public company), while continuing to present the comparative periods under Topic 840 (the legacy leases guidance). If an entity elects the new transition method, it is required to provide the Topic 840 disclosures for all prior periods that remain under the legacy leases guidance.

This additional transition method changes only **when** an entity initially applies the transition requirements of Topic 842, it does not change **how** to apply those requirements.

BDO Observation:
We believe many entities will take advantage of this new transition method considering the cost savings it offers. However, even with this relief, entities should not delay their implementation projects, given the amount of effort still required.

This new update is the third ASU to amend the transition provisions in Topic 842. Since neither of the first two ASUs[3] summarizes all of the transition-related provisions and changes thereof, entities may find it helpful to review the aggregate effect of the amendments in this latest ASU (ASU 2018-11), since it incorporates them all.

Separating Components of a Contract by Lessors

The new leases standard generally requires entities to separate the lease and nonlease components of a contract and account for each component under the relevant accounting guidance. Lessees were given a practical expedient whereby they could make an accounting policy election, by asset class, to not separate the components and to simply account for them as a single lease component. Prior to this ASU, lessors were not provided such an option.

The amendments in this ASU provide lessors with a practical expedient by asset class similar to the option lessees have; however, limitations apply for lessors. In order for a lessor to qualify for the practical expedient and account for the nonlease components and associated lease component as a combined (i.e., single) component, the nonlease components must first be in the scope of the new revenue guidance (i.e., Topic 606) and both of the following conditions must be met:

1. The timing and pattern of transfer of the nonlease component(s) and associated lease component are the same.

2. The lease component, if accounted for separately, would be classified as an operating lease.

When the above conditions are met, the entity will need to assess predominance. If the nonlease components are predominant, the entity accounts for the combined component under Topic 606; otherwise, the entity accounts for the combined component under Topic 842. In addition, a lessor that elects the practical expedient must combine all nonlease components that qualify for the practical expedient with the associated lease component. A lessor should continue to separately account for nonlease components that do not qualify for the practical expedient.

NONLEASE COMPONENT(S) PREDOMINANT

- Account for the combined component as a single performance obligation under Topic 606.
- Account for single performance obligation using over time, time-based measure of progress.
- Apply the variable consideration guidance under Topic 606, including the constraint, for all variable payments (including those that previously related to the lease component because it now is part of a single revenue component).

3 ASU 2018-01 and ASU 2018-10

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LEASE COMPONENT PREDOMINANT

- Account for the combined component as a single lease component under Topic 842.
- Account for the combined component as an operating lease (i.e., the lessor should not perform a lease classification test),
- Account for all variable payments related to any good or service that is part of the combined component as variable lease payments (i.e., do not estimate variable payments; rather recognize those payments in accordance with ASC 842-10-15-40).

Further, the following additional disclosures should be provided when a lessor elects the practical expedient (including when the combined component is accounted for under Topic 606):

1. The fact that the entity elected the expedient,
2. Which asset classes are affected,
3. The nature of (a) the lease component and nonlease component(s) that were combined as a result of applying the practical expedient and (b) any nonlease components that were not eligible for the practical expedient and, thus, not combined,
4. The Topic the entity applies to the combined component (i.e., Topic 606 or Topic 842).

BDO Observation:
We believe many entities (including real estate entities and cable companies) will welcome this lessor practical expedient as it generally will enable them to account for their transactions under the new lease or revenue standards in a manner similar to how they have accounted for them in the past.

The following considerations are important in understanding (and evaluating whether a lessor qualifies for) the practical expedient:

- The practical expedient applies only to nonlease components that otherwise would be accounted for under Topic 606. It does not apply, for example, to a contract that includes a lease component and a loan component accounted for under Topic 310 on receivables.
- Because of the condition that the lease component be classified as an operating lease if separated, this means that the timing and pattern of transfer of the nonlease components also must be straight-line (i.e., over time, time-based) to qualify for the practical expedient.
- Determining whether the lease component would be classified as an operating lease if accounted for separately generally should not require a detailed quantitative analysis and may often be determined using a reasonable qualitative assessment.
- A lessor should be able to reasonably determine which component is predominant (i.e., a lessor does not have to perform a detailed quantitative analysis or theoretical allocation). We believe entities may use a >50% threshold in determining which component is predominant for this lessor practical expedient, even though this may not necessarily align with how the concept of predominance is described under Topic 606.[4]

When a contract includes a lease component and multiple nonlease components, the fact that some nonlease components do not meet the conditions for combining (e.g., a nonlease component that transfers at a point-in-time) does not preclude the lessor from qualifying for the practical expedient. However, in those situations the lessor must combine all nonlease components that qualify with the associated lease component, and account for those as a single component. The nonlease components that do not qualify should be accounted for separately. Accordingly, the lessor is required to separate and allocate the consideration in the contract between the combined component on one hand and the nonlease components that do not qualify on the other hand.

4 Topic 606 uses the concept of predominance when discussing the sales-based and usage-based royalty exception for licenses of intellectual property. That guidance notes that "... the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe **significantly** more value to the license than to the other goods or services to which the royalty relates [emphasis added]".

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EFFECTIVE DATE AND TRANSITION FOR LESSOR PRACTICAL EXPEDIENT

The amendments in this ASU related to the lessor practical expedient affect the amendments in ASU 2016-02, which are not yet effective but can be early adopted.

For entities that have not adopted ASU 2016-02 before the issuance of this ASU, the effective date and transition requirements for the amendments in this ASU for the practical expedient are the same as the effective date and transition requirements in ASU 2016-02.

For entities that have adopted ASU 2016-02 before the issuance of this ASU, the transition and effective date of the amendments in this ASU for the practical expedient are as follows:

1. The practical expedient may be elected either in the first reporting period following the issuance of this ASU or at the original effective date of Topic 842 for that entity. For example, a calendar year-end public company that early adopted Topic 842 may elect the practical expedient either during Q4, 2018 (the first reporting period following the issuance of the ASU) or on January 1, 2019 (its original effective date if it had not early adopted).
2. The practical expedient may be applied either retrospectively or prospectively.

All entities, including early adopters, that elect the lessor practical expedient must apply the expedient by asset class to all existing lease transactions that qualify for the expedient at the date elected.

BDO Observation:
It is important for entities to note that the decision to elect (or not elect) the lessor practical expedient should be made for existing asset classes at the adoption date of the amendments in this ASU. If elected, the transition provisions in the ASU require a lessor to apply the practical expedient to all new and existing lease transactions within that asset class.

For example, a calendar year-end public company that adopts the new leases standard (and the amendments in this ASU) on January 1, 2019 would first need to determine at that date the existing asset classes for which it wishes to elect the practical expedient. Then, for the selected asset classes, the entity would apply the lessor practical expedient to all of the existing leases that are actually eligible for the expedient.

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