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To the Point

FASB — final guidance

FASB adds transition option and practical expedient for lessors to new leases standard

The amendments respond to implementation challenges identified by stakeholders.

What you need to know

- The FASB amended the new leases standard to give entities another option for transition and to provide lessors with a practical expedient.
- The transition option allows entities to not apply the new leases standard in the comparative periods they present in their financial statements in the year of adoption.
- The practical expedient provides lessors with an option to not separate non-lease components from the associated lease components when certain criteria are met and requires them to account for the combined component in accordance with the new revenue standard if the associated non-lease components are the predominant components.
- The amendments have the same effective date as the new leases guidance. Lessors that early adopted that guidance can apply the expedient before the effective date.

Overview

The Financial Accounting Standards Board (FASB or Board) added a transition option and a practical expedient for lessors[1] to Accounting Standards Codification (ASC) 842, *Leases*, to reduce the cost and complexity of implementing the new standard.

With the transition option, the FASB is responding to concerns raised by entities, particularly those that plan to implement new systems to comply with the guidance. These entities said that requiring them to apply the new leases standard to the comparative periods presented in the year of adoption would be more costly and complex for them to implement than the FASB initially anticipated.

With the practical expedient for lessors, the FASB is responding to concerns raised by stakeholders about the difficulty of determining standalone selling prices for lease and non-lease components that aren't sold separately and the relevance of information about the separate components to users of the financial statements.

Key considerations

Additional transition method

Under the transition option, entities can opt to continue to apply the legacy guidance in ASC 840, *Leases*, including its disclosure requirements, in the comparative periods presented in the year they adopt the new leases standard. That means entities that elect this option will make only annual disclosures for the comparative periods because ASC 840 doesn't require interim disclosures.

Entities that elect this transition option still adopt the new leases standard using the modified retrospective transition method required by the standard, but they recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption rather than in the earliest period presented. That is, the only difference is the timing of when an entity applies the modified retrospective transition provisions.

For example, a calendar-year entity that adopts the standard on 1 January 2019 and elects this transition option will apply the transition provisions on 1 January 2019 (i.e., the effective date). If the entity didn't elect this transition option and it presents two years of comparative financial statements, it would apply the transition provisions on 1 January 2017 (i.e., the beginning of the earliest comparative period presented).

In the post-adoption period, different recognition and measurement requirements will still apply to leases entered into before the effective date and those entered into (or modified) after the effective date.

How we see it

We believe the transition option will mitigate some of the costs and complexities associated with the adoption of the new leases standard. However, the effective date of the new leases standard has not changed, and the level of effort necessary to apply the new standard by the effective date may be significant. Entities should therefore remain focused on their implementation efforts, regardless of whether they plan to elect the new transition option.

Lessor option to combine lease and non-lease components

The optional practical expedient allows lessors to elect, by class of underlying asset, to not separate non-lease components from the associated lease components if the non-lease components otherwise would be accounted for in accordance with the new revenue standard and both of the following criteria are met:

- The lease component and the associated non-lease components have the same timing and pattern of transfer.
- The lease component, if accounted for separately, would be classified as an operating lease.

The new leases standard initially required lessors to separate a contract's lease components from non-lease components, such as maintenance services or other activities that transfer a good or service to the lessee. The lease components were to be accounted for in accordance with the new leases standard while the non-lease components were to be accounted for in accordance with other guidance (e.g., the new revenue standard). Consideration in the arrangement would then be allocated to the lease and non-lease components.

Under the new optional practical expedient, a lessor that determines that the non-lease component or components associated with the lease component are the predominant components in the contract is required to account for the combined component in accordance with ASC 606. If the non-lease components aren't the predominant components, the lessor accounts for the combined component as an operating lease in accordance with ASC 842. An entity that elects the lessor practical expedient for a class of underlying asset must apply the expedient to all qualifying leases in that class and provide certain disclosures.

In determining whether a non-lease component or components are the predominant component(s) in a combined component, a lessor must consider whether the lessee would be reasonably expected to ascribe more value to the non-lease components than to the lease component. The Board said in BC35 of the Background Information and Basis for Conclusions of the Accounting Standards Update (ASU) that a lessor should be able to reasonably determine which guidance to apply (based on predominance) without having to perform a detailed quantitative analysis or theoretical allocation to each component.

How we see it

The practical expedient provides relief by permitting lessors to combine non-lease and associated lease components, if certain criteria are met. But determining whether the lease component would be classified as an operating lease and identifying the predominant component (i.e., the component the lessee is reasonably expected to ascribe significantly more value to) will require judgment.

Entities that elect this practical expedient may be required to account for the combined component in accordance with ASC 606.

A lessor that elects the practical expedient is required to apply it consistently to all non-lease components eligible to be combined with lease components. That is, an entity cannot pick and choose which lease and non-lease components to combine. For non-lease components that do not qualify for the practical expedient, a lessor will allocate consideration to those components on a relative standalone selling price basis and account for those non-lease components in accordance with the new revenue standard.

Effective date and transition

The amendments have the same effective date as the new leases standard, and the lessor expedient to combine components has the same transition requirements. Entities that early adopted the new leases standard may apply the lessor expedient either in the first reporting period following the issuance of the ASU or on the date they would have been required to adopt ASC 842 and may apply the expedient either retrospectively or prospectively.

As a reminder, the new leases standard is effective for public business entities, certain not-for-profit entities and certain employee benefit plans for annual periods beginning after15 December 2018 (i.e., 1 January 2019 for calendar-year entities) and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019 (i.e., 1 January 2020 for calendar-year entities) and interim periods the following year.

Endnote:

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[1] ASU 2018-11, *Leases (Topic 842): Targeted Improvements*.