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FASB proposes more changes to lessor accounting

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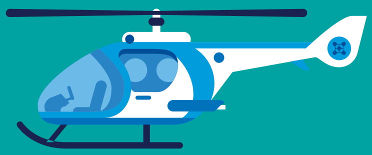

KPMG reports on the FASB's lessor accounting proposals[1] and the SEC staff's guidance on updating the foreign exchange rate used to remeasure an ROU asset.

Applicability

- **Fair value of underlying asset.** Lessors that are not manufacturers or dealers.
- **Cash flow presentation.** Lessors that are depository or lending institutions in the scope of ASC 942[2] that enter into sales-type or direct financing leases.
- **Updating exchange rate used to remeasure a right-of-use (ROU) asset.** Lessees that enter into leases denominated in a foreign currency that is not their functional currency.

Key facts and impacts

Fair value of the underlying asset. The proposed ASU would reinstate the specific fair value guidance in ASC 840[3] for lessors that are not manufacturers or dealers that ordinarily requires them to measure the fair value of an underlying asset at its cost.

The fair value would reflect any volume or trade discounts that apply, and include costs incurred to acquire the asset (e.g. sales taxes and delivery costs).

However, if a significant amount of time has lapsed between the asset acquisition date and lease commencement, the fair value would be based on the definition in ASC 820.[4]

Cash flow presentation. Lessors that are depository or lending institutions in the scope of ASC 942 would present the principal portion of lessee payments made on sales-type or direct financing leases as cash flows from investing activities, and the interest portion as cash flows from operating activities. This would be consistent with how they classify similar cash flows from other lending activities.

All other lessors would continue to present lessee payments made on sales-type or direct financing leases entirely as cash flows from operating activities.

Updating exchange rate used to remeasure an ROU asset. Lessees can elect one of two acceptable approaches when deciding whether and how to update the exchange rate used to remeasure the ROU asset into the lessee's functional currency when a lease is denominated in a currency other than the functional currency.

[1] Proposed ASU, Leases (Topic 842): Codification Improvements for Lessors

[2] ASC 942, Financial Services—Depository and Lending

[3] ASC 840, Leases

[4] ASC 820, Fair Value Measurement

FASB proposed ASU

Fair value of underlying asset

ASC 820 defines fair value as "the price that would be received to sell an asset…in an orderly transaction between market participants at the measurement date." This is commonly referred to as an 'exit price' notion.

ASC 820 provides an exception from the definition of fair value for leases before adoption of ASC 842.[5] The exception is not an election and applies to both lessees and lessors regardless of whether the lessor is a manufacturer or dealer.

ASC 840 provides specific guidance about measuring the fair value of an underlying asset ('leased property') that applies to all leases of lessors. The guidance specific to leases of lessors that are not manufacturers or dealers is consistent with the proposed ASU.[6]

ASU 2016-02[7] eliminated the ASC 820 fair value exception for leases, and ASC 842 does not include any specific fair value guidance for lessors that are not manufacturers or dealers. As a result, when lessors adopt ASC 842 they are required to measure the fair value of an underlying asset based on the exit price notion in ASC 820.

The proposed ASU would not reinstate the broad fair value exception in ASC 820 that applies to all leases. Instead, it would reinstate the specific fair value guidance from ASC 840 only for lessors that are not manufacturers or dealers.

KPMG observation

Lessors' accounting - ASC 840

Lessors that are not manufacturers or dealers – e.g. many financial institutions and captive finance companies – frequently incur costs to acquire an asset that is subsequently leased to a customer. Acquisition costs include sales taxes, shipping or delivery charges and installation costs, among other costs.

These costs form part of the cost basis of the underlying asset. Then, because of ASC 840's specific fair value guidance, those costs are also included in the fair value of the underlying asset such that they become part of the net investment in the lease when it is a sales-type or direct financing lease.

The lessor's implicit rate, which drives the interest income earned over the lease term, is lower than it would be if the costs were not included in the underlying asset's fair value.

Lessors' accounting - ASC 842 (as issued)

While acquisition costs remain part of the cost basis of the underlying asset, the asset's fair value, determined using ASC 820's fair value definition, does **not** include those costs.

Therefore, the costs are not included in the net investment in a sales-type or direct financing lease, and the lessor's implicit rate is higher under ASC 842 than it was for the same lease under ASC 840.

Because the carrying amount of the underlying asset, including the acquisition costs, is greater than the net investment in the lease, lessors asserted that for new sales-type or direct financing leases commencing on or after the effective date of ASC 842 they would:

- recognize a loss at lease commencement for the difference; and
- recognize interest income over the lease term that is generally greater than what would have been recognized on the same lease under ASC 840.

Effect of the FASB's proposed ASU

Acquisition costs would, once again, generally be included in the measurement of fair value of the underlying asset (if a significant amount of time has not lapsed between the asset acquisition date and lease commencement). Therefore, the proposed ASU would effectively revert affected lessors' accounting under ASC 842 to what it was under ASC 840 for underlying asset acquisition costs.

In the Basis for Conclusions to the proposed ASU, the FASB explains that it decided to propose this change because Board members did not intend to significantly change the accounting for non-manufacturer or dealer lessors in this manner. The Board further indicates that it expects that the proposed ASU would result in affected lessors' accounting for underlying asset acquisition costs remaining consistent with current practice under ASC 840.

[5] ASC 820-10-15-2(c); ASC 842, Leases

[6] ASC 840-10-55-44

[7] ASU 2016-02, Leases (Topic 842)

Cash flow presentation

ASC 840 does not provide guidance on how lessee payments in sales-type and direct financing leases should be presented by a lessor in its statement of cash flows. However, it has been a common practice for lessors to classify the principal portion of lessee payments in sales-type and direct financing leases as cash flows received from investing activities. Financial institution lessors have typically followed this practice in order to be consistent with their treatment of customer payments on loans.

In contrast, ASC 842 contains explicit guidance on lessor cash flow presentation. It requires lessors to present all cash receipts from leases as cash flows from operating activities.[8]

Despite ASC 842's explicit guidance, ASC 942 continues (as it did before ASU 2016-02) to include a statement of cash flows example that illustrates a depository or lending institution lessor presenting the principal portion of lessee payments in sales-type and/or direct financing leases as cash flows from investing activities.

Consequently for lessors in the scope of ASC 942, there is conflicting guidance about how cash receipts should be presented in the statement of cash flows.

The proposed ASU would amend ASC 842 and ASC 942 to clarify that lessors in the scope of ASC 942 are required to present:

- the principal portion of lessee payments received on sales-type and direct financing leases as cash flows from investing activities (consistent with the classification of similar cash flows from other lending activities); and
- all other lessee payments as cash flows from operating activities – i.e. the interest portion of lessee payments received on sales-type and direct financing leases and all lessee payments received on operating leases.

Lessors not in the scope of ASC 942 will present all lessee payments from leases as cash flows from operating activities in the statement of cash flows.

KPMG observation

In response to a technical inquiry from a lessor in the scope of ASC 942, the FASB staff previously communicated that, because of the conflicting guidance in ASC 842 and ASC 942, it would not object to lessors in the scope of ASC 942 making an accounting policy election to either:

- present all lessee payments in the statement of cash flows as cash flows from operating activities, consistent with the requirement for all other lessors; or
- present lessee payments in the statement of cash flows consistent with the proposed ASU.

However, the proposed ASU would supersede this FASB staff guidance. Lessors in the scope of ASC 942 would no longer be permitted to elect the first option.

Effective dates and transition

For public business entities, the proposed ASU would be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the proposed ASU would be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

All entities would be permitted to early adopt the ASU concurrent with, or any time after, they adopt ASC 842. Entities that adopt the ASU after they adopt ASC 842 would retrospectively apply the proposed ASU from their ASC 842 adoption date (if using the effective date transition method) or the beginning of the earliest period presented in their post-ASC 842 adoption financial statements (if using the comparative transition method).[9]

Next steps

Comments on the proposed ASU are due January 15, 2019.

SEC staff guidance on updating exchange rates

In response to a consultation request, the SEC staff recently communicated that it would not object to lessees adopting either of the following

[8] ASC 842-30-45-5

[9] See Chapter 13A and Chapter 13B in KPMG's Handbook, Leases, for more information on the effective date and comparative transition methods, respectively.

approaches, as an accounting policy election, to updating the exchange rate used to remeasure an ROU asset into the lessee's functional currency when the lease is denominated in a currency other than the functional currency:

Approach 1

- Reset the exchange rate when the lease is either:
  - modified (and the modification is not accounted for as a separate contract); or
  - remeasured because of a change in the lease term or the assessment of a lessee option to purchase the underlying asset; **and**
- do not change the exchange rate if the lease is remeasured solely for either:
  - a change in amount probable of being owed under a residual value guarantee; or
  - the resolution of a contingency that results in variable lease payments becoming fixed.

Approach 2

- Treat any increases to the original carrying amount of the ROU asset (net of accumulated amortization) after lease commencement as a new 'layer' of the ROU asset.
- On a remeasurement event that increases the carrying amount of the ROU asset, assign an updated exchange rate to **only** the new layer.

Question 6.4.25 in our Handbook, Leases, provides additional detail.

Contributing authors
Jared Hirashima; Scott Muir

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