



Defining Issues[®]

FASB agrees to further amend the Leases standard

November 29, 2017

KPMG reports on decisions made at the November 29, 2017 FASB meeting. The Board decided to finalize its proposed ASU on land easements¹ and propose practical expedients on transition and lessor accounting for lease and non-lease components.

Applicability

Optional transition relief

All companies within the scope of the new leases standard.²

Lessor separation of lease and non-lease components

Lessors with contracts that contain lease and non-lease components (e.g. common area and other forms of maintenance services, operational services).

Land easements

Companies with land easements, particularly in the energy, utilities, transportation and telecom industries.

Key facts and impacts

The Board decided to propose an amendment to give all companies the option to use the effective date of the new leases standard as their date of initial application in transition. Companies that elect this transition option would not have to adjust their comparative period financial

statements (e.g. 2017 and 2018 financial statements for a public company) for effects of the new standard or make the new required lease disclosures for periods before the effective date.

The Board's decision on lease and non-lease components would permit lessors, who meet specific requirements, as an accounting policy election by class of underlying asset, to not separate non-lease components of a contract from the lease component to which they relate. The combined component would be treated as a single *lease* component.

The Board's decision to finalize its proposed amendments on land easements means it will issue a final ASU clarifying that land easements are within the scope of the new leases standard, as well as providing a practical expedient for land easements in transition. Companies will not be required to assess whether land easements that commence before the effective date of the new standard are or contain leases if those easements were not previously accounted for as leases under current US GAAP.³

¹ Proposed ASU, [Land Easement Practical Expedient for Transition to Topic 842](#)

² ASC 842, Leases

³ ASC 840, Leases

Optional transition relief

The new leases standard presently requires a modified retrospective transition approach, with application (including disclosures) in all comparative periods presented. Therefore, for a public company with a January 1, 2019 effective date, its date of initial application – i.e. the date at which it first recognizes new right-of-use (ROU) assets and lease liabilities for existing operating leases, and recognizes its transition adjustment – is January 1, 2017.⁴

The Board’s decision would permit a company to use its effective date as the date of initial application. Therefore, the company:

- would not restate comparative period financial information for the effects of the new standard;
- would not make the new required lease disclosures in comparative periods beginning prior to the effective date; and
- would recognize its cumulative effect transition adjustment (e.g. for the effect of any unamortized initial direct costs that are required to be written-off at transition) as of the effective date.

KPMG observation

Eliminating the requirement for comparative period reporting may ease, to some extent, the burden of transition. In particular, eliminating the requirements to provide comparative period disclosures and revise comparative period financial statements for changes such as foreign currency effects may provide substantial relief to many companies.

Some FASB stakeholders requested this transition relief largely on the basis that lease IT systems to assist with the application of the new standard, including comparative period effects and disclosures, are not yet broadly available for implementation even though their date of initial application has passed absent this potential transition relief.

Even with comparative period transition relief, companies should remain diligent in their efforts to implement the new leases standard. The Board’s decision, if enacted, would not change any other aspects of a company’s transition accounting, and accordingly, companies will still need to evaluate systems, processes and internal controls to capture complete and accurate lease data necessary to prepare the cumulative effect adjustment that would now be required as of the effective date. We believe the time and resources required to obtain all the information required to implement the new leases standard will still be significant and, even with this potential relief, the effective date is just over one year away for many companies. Because of that, companies should not significantly alter their implementation timeline based on the Board’s decision to propose this transition relief.

Furthermore, in preparing their ASC 840 lease disclosures for periods preceding the effective date, companies should consider to what extent financial statement users will focus more closely on those disclosures in order to obtain comparative financial information.

Lessor separation of lease and non-lease components

The new leases standard presently requires lessors to separate lease components from non-lease components of a contract in all cases.⁵ Lessors then allocate the consideration in the contract to each separate lease and non-lease component based on the transaction price allocation guidance in the new revenue standard.⁶

Even when separation does not affect the amount or timing of total (lease and non-lease) revenue recognition, lessors must separate lease and non-lease components and allocate consideration among those components to meet the separate disclosure requirements in ASC 842 and ASC 606, respectively. Furthermore, public companies have to consider the SEC presentation requirements to state separately rental income from service and tangible product revenues.⁷

⁴ See [Section 13.2](#) of KPMG’s Handbook, [Leases](#)

⁵ See [Section 4.4](#) of KPMG’s Handbook, [Leases](#)

⁶ See [Chapter 6](#) of KPMG’s Handbook, [Revenue Recognition](#)

⁷ Rule 5-03(b) of Regulation S-X

Many lessors have expressed to the Board that the requirement to separately account for lease and non-lease components when the effect relates only to presentation and disclosure – i.e. the separation of the components has no effect on the amount or timing of revenue recognition – is costly, complex and provides minimal, if any, benefit to financial statement users.

In response to this feedback, the Board decided to propose a practical expedient whereby a lessor would be permitted not to separate lease and non-lease components when the effect of doing so is only one of presentation and disclosure. This practical expedient would be available only if the pattern of revenue recognition for the combined component is the same as it would be for each of the components accounted for separately. In addition, if combining the components were to result in a different lease classification than the

classification for the lease-only component (e.g. because of the consideration of the non-lease payments in the present value classification test), then the practical expedient would not be available. Components that are combined using this practical expedient would be accounted for as a single lease component, following the presentation and disclosure requirements in the new leases standard for the combined component.

This practical expedient would be an accounting policy election, elected by class of underlying asset. A lessor electing this expedient would disclose its election and to which classes of underlying assets it is being applied. In addition, the lessor would disclose the nature of any non-lease components it is combining with lease components.

KPMG observations

The Board's decision to provide this lessor separation and allocation practical expedient, if finalized, will likely provide significant relief to many entities, particularly in the real estate industry, for whom separating and allocating consideration to lease and non-lease components will be costly and complex with little, if any, perceived financial reporting benefit when there is no effect on the amount or timing of total revenue recognition.

Many Board members, in expressing their support for this potential practical expedient, noted that the new revenue standard permits companies not to separately account for goods or services that are delivered concurrently and have the same pattern of transfer to the customer.^{8, 9} Those Board members explained that in their view, consistent with the Basis for Conclusions to ASU 2016-02, leasing is fundamentally a revenue-generating activity for lessors and, therefore, lessors should be able to avail themselves of the same expedient afforded to companies whose contracts are entirely within the scope of the new revenue standard when the lease and the non-lease components are provided concurrently and have the same pattern of transfer to the customer.

While this proposed practical expedient will likely provide substantial relief to companies with significant lease components and relatively minor non-lease components (e.g. real estate leases in which the lessor also provides common area maintenance), this expedient may not provide relief to companies entering into contracts that are predominantly service or supply arrangements, but also include an embedded lease. This is because the Board's decision would require the combined lease/non-lease component to be accounted for and disclosed as a single *lease* component. Companies whose arrangements are predominantly to provide a service or for the supply of a good may not find it useful or practicable to present and disclose the entire arrangement as a lease – i.e. it may distort the nature of their contracts with customers. In addition, many of those companies may not be eligible for the practical expedient because the inclusion of the non-lease payments may result in a different lease classification from that of the lease component accounted for separately (e.g. the combined component may be classified as a sales-type lease, while the lease component accounted for separately would be an operating lease).

⁸ ASC 606, Revenue from Contracts with Customers

⁹ See [section 4.3.10](#) of KPMG's Handbook, Revenue Recognition and paragraph BC116 of ASU [2014-09](#)

Land easements

A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specific purpose. The FASB decided to provide optional transition relief because many constituents said that it was not clear whether land easements were within the scope of the current leasing guidance. As a result, some companies had not assessed whether their existing land easements met the current definition of a lease.

The Board's decision means that a final ASU will be issued that both:

- specifies that land easements – as rights to use land – are within the scope of the new leases standard and should be analyzed to determine if they meet the new definition of a lease. If a company determines the land

easement is not a lease, only then should it apply other guidance - e.g. the guidance on intangible assets.

- grants an optional practical expedient that permits a company at transition to not assess whether expired or existing land easements are or contain leases that they had not previously accounted for as leases under current US GAAP. This practical expedient would be available individually, or in conjunction with either or both of the existing transition practical expedients in the new standard – i.e. the 'package of practical expedients' and the use of hindsight.¹⁰

The Board decided not to make amendments to the new leases standard to clarify how to apply the new definition of a lease to land easements.

KPMG observations

Basis for current accounting

The practical effect of this expedient will be to grandfather the accounting for any easement that the entity concluded did not meet the current definition of a lease, even if that conclusion was reached in error – i.e. rather than as a result of concluding the easement was outside the scope of the current leases guidance.

Consistent accounting policies

The Basis for Conclusions to the proposed ASU expressed that, during transition, a company should continue to consistently account for contracts entered into before the effective date of the new standard by following its existing policies. This applies to existing land easements as well as new arrangements that might be entered into before a company adopts the new standard. For example, a new ground lease agreement (that could be characterized as a land easement) would not be eligible for the practical expedient if similar ground leases had been accounted for as leases under the current lease accounting guidance. Any departure from a company's current accounting policy would be subject to the guidance on accounting changes.¹¹

Applying the new definition of a lease to land easements

Even though the Board decided not to provide additional guidance on applying the definition of a lease to land easements, the Basis for Conclusions to the proposed ASU indicated that the Board does not believe perpetual easements meet the definition of a lease. This is consistent with Question [3.1.10](#) of KPMG's Handbook, Leases.

Questions [3.2.20](#) and [3.3.90](#) of KPMG's Handbook, Leases further discuss assessing land easements under the new standard's definition of a lease.

At the November 29 meeting, the FASB staff and some FASB members discussed issues related to the 'unit of account' for assessing whether a land easement meets the definition of a lease. The FASB staff reminded companies to apply the guidance on implicit asset specification that exists in the new standard. Board members further noted that identifying the asset to assess against the lease definition may require judgment, but that judgment is not unique to land easement arrangements so they did not think it necessitated changes to the new leases standard. Identifying the asset(s) to be evaluated under the new definition of a lease is not a 'free choice' and needs to be anchored to the identified asset guidance in the new standard.

¹⁰ See [Section 13.2.3](#) of KPMG's Handbook, [Leases](#)

¹¹ ASC 250, Accounting Changes and Error Corrections

Effective dates and transition

The Board did not discuss effective dates for the proposed transition relief or the practical expedient on lessor separation of lease and non-lease components.

The effective date of the final land easements ASU will coincide with the effective date of the new leases standard for companies that have not early adopted. For companies that have early adopted the new standard, the final ASU will be effective upon issuance.

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Next steps

The FASB will issue a final ASU on land easements and a proposed ASU on transition relief and lessor separation of lease and non-lease components of a contract. The FASB staff indicated a proposed ASU on transition relief and lessor separation of lease and non-lease components likely will be issued in January 2018. The Board decided that the proposed ASU should be exposed for public comment for a period of 30 days.