KPMG

Hot Topic: ASC 842

Lessor accounting for operating lease receivables

July 22, 2019

This Hot Topic addresses a series of questions about lessors' accounting for operating lease receivables after the adoption of Topic 842.

Applicability

This Hot Topic applies only to lessors' accounting for operating leases. Section 7.5 of KPMG's Handbook, Leases discusses collectibility for sales-type and direct financing leases.

In addition, this Hot Topic applies only to issues related to the collectibility of operating lease receivables arising from lessee credit issues; it does not apply to assessing the collectibility of receivables that pertain to disputed charges.

Key impacts

The FASB staff recently responded to a multi-faceted technical inquiry about lessors' accounting for operating lease receivables after the adoption of Topic 842 (leases). Many aspects of the inquiry arose because of the FASB's decision to exclude operating lease receivables from the scope of the credit losses guidance in Topic 326. The following are what we believe to be the key takeaways from the FASB staff's response.

— The collectibility guidance in Subtopic 842-30 requires an ongoing lease-by-lease assessment of the collectibility of the lease payments for operating leases throughout the lease term (see Questions 1 and 2).[1]

— For operating leases where collectibility of substantially all the lease payments is not probable (i.e. subject to the 'collectibility constraint'), operating lease receivables – including those arising from

[1] For ease of reading, 'collectibility of the lease payments' should be understood to include collectibility of any amount necessary to satisfy a residual value guarantee of the lessee or an unrelated third party.

the straight-line recognition of operating lease revenue – should be fully reserved for in the lessor's financial reporting (see Question 3).

- For operating leases not subject to the collectibility constraint, lessors are permitted to establish and maintain a general collectibility reserve under Subtopic 450-20 (loss contingencies) for those lease receivables, but are not required to do so (see Question 4).
- For lessors that use a general collectibility reserve under Subtopic 450-20:
  - it is acceptable to record changes to that reserve through either lease revenue or bad debt expense (see Question 5); and
  - there are multiple acceptable approaches to the accounting for an operating lease that becomes subject to the 'collectibility constraint' after lease commencement (see Question 6).

Contracts with lease and non-lease components

The FASB decided to exclude operating lease receivables from the scope of Topic 326, while including trade receivables and contract assets arising from non-lease components subject to Topic 606 (revenue from contracts with customers) in its scope. Because many operating lease contracts include non-lease components, the FASB's decision may create operational complexity for those lessors that enter into operating lease contracts that include non-lease components.

Unless the lessor can account for the operating lease and any non-lease component(s) of the contract as a single component using the optional lessor practical expedient to not separate lease and non-lease components,[2] the receivables arising from the contract will be subject to two different credit impairment models.

Background

Topic 842 guidance

Topic 842 requires lessors with operating leases to assess whether collectibility of the 'lease payments'[3] plus any amount necessary to satisfy a residual value guarantee (provided by the lessee or another unrelated third party) is probable at the commencement date. This is an assessment that must occur at lease commencement, and be reassessed for changes in facts and circumstances throughout the lease term. [842-30-25-12 – 25-13]

If collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee is not probable at the commencement date, cumulative lease income is limited to the lesser of: [842-30-25-12]

a. the income that would be recognized in accordance with the guidance applicable to all operating leases; or

b. the amount of the lease payments, including variable lease payments, that have been collected from the lessee.

If the assessment of collectibility changes after the commencement date, any difference between (a) and (b) is recognized as a current-period adjustment to lease income. [842-30-25-13]

Topic 842 (like Topic 840) does not include guidance about the valuation of operating lease receivables.

[2] See section 4.4.1 of KPMG's Handbook, Leases for further information about the lessor non-separation practical expedient.
[3] See section 5.4 of KPMG's Handbook, Leases for information about what constitutes 'lease payments'.

Financial instruments guidance

Before the adoption of Topic 326, Topic 310 (receivables) directs entities to Subtopic 450-20 (loss contingencies) when assessing the impairment of receivables not 'specifically addressed by other Topics'. [310-10-35-2]

Topic 326 supersedes the guidance in Topic 310 on the impairment of receivables, but operating lease receivables are explicitly excluded from the scope of Topic 326. [326-20-15-3(g)]

Question 1

Does Topic 842 require lessors to assess collectibility for operating leases on a lease-by-lease basis?

Interpretive response: Yes. Collectibility must be assessed for each operating lease. While we believe this is established by the guidance in Subtopic 842-30, it was also affirmed by the FASB staff as part of their response to the recent technical inquiry. [842-30-25-12 – 25-13, ASU 2016-02.BC105]

Question 2

Does Topic 842 require lessors to reassess collectibility throughout the lease term?

Interpretive response: Yes. Subtopic 842-30 includes guidance about accounting for changes in the assessment of collectibility for an operating lease 'after the commencement date', clearly indicating that collectibility for an operating lease is an ongoing assessment throughout the lease term. The intent of the guidance in this regard was affirmed by the FASB staff as part of their response to the recent technical inquiry. [842-30-25-13]

Question 3

Should operating lease receivables pertaining to leases subject to the collectibility constraint be fully reserved for on the lessor's balance sheet?

Interpretive response: Yes. If, at lease commencement, an operating lease is subject to the collectibility constraint, no receivables for that lease should be recognized on the lessor's balance sheet until collectibility of substantially all of the lease payments becomes probable. A lessor may accomplish this by either not recognizing the receivables, or fully reserving for those receivables through an allowance.

If an operating lease is *not* subject to the collectibility constraint at lease commencement, but becomes subject to it during the lease term, a reserve should be established for 100% of any outstanding lease receivables.

Question 4

Should a lessor recognize a reserve for operating lease receivables not related to leases subject to the collectibility constraint after the adoption of Topic 842?

Interpretive response: Based on the technical inquiry with the FASB staff, we believe either of the following two accounting policies is acceptable.

Approach 1: Follow Subtopic 842-30 guidance only

The basis for conclusions to ASU 2018-19,[4] which scoped operating lease receivables out of Topic 326, could be read to indicate that the Subtopic 842-30 collectibility guidance is the only guidance to apply when considering impairment of operating lease receivables. [ASU 2018-19 Summary, ASU 2018-19.BC14]

Consequently, operating lease receivables should be impaired (i.e. written off or reserved for) only when the lease is subject to the collectibility constraint. No 'general reserve' should be established or maintained for other operating lease receivables.

Approach 2: Establish a general reserve based on Subtopic 450-20

In deciding to exclude operating lease receivables from the scope of Topic 326, the FASB reiterated its intent, originally expressed in the basis for conclusions to ASU 2016-02,[5] not to *significantly* change lessors' accounting for operating leases. [ASU 2016-02.BC90–BC92, ASU 2018-19.BC13]

Excluding operating lease receivables from the scope of Topic 326 was intended to be consistent with the intent not to significantly change operating lease accounting, *not* to preclude lessors from recording a general reserve for operating lease receivables *after* applying the collectibility constraint guidance in Subtopic 842-30. Therefore, the FASB staff believes it is acceptable for a lessor to recognize a reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.

Applying Approach 2 does not affect a lessor's requirement to fully reserve for operating lease receivables subject to the collectibility constraint (see Question 3).

Question 5

If a lessor follows Approach 2 to Question 4, should the general reserve be recorded through a reduction to lease revenue or bad debt expense?

Interpretive response: Based on the technical inquiry with the FASB staff, we believe either of the following two accounting policies is acceptable.

Approach 1: Record changes to the reserve through lease revenue

All changes to the balance of the general collectibility reserve (i.e. increases and decreases) established under Subtopic 450-20 are recorded through lease revenue. This approach generally results in consistency in the income statement between where lessors (1) record changes to their general reserve, and (2) record the effect of a lease becoming subject to, or leaving, the collectibility constraint.

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[4] ASU No. 2018-19, Codification Improvements to Topic 326, Financial Instruments—Credit Losses
[5] ASU No. 2016-02, Leases (Topic 842)

Approach 2: Record bad debt expense

All changes to the balance of the *general* reserve (see Question 5) are recorded through bad debt expense. In accepting this approach, the FASB staff again cited the FASB's expressed intent not to *significantly* change lessors' accounting for operating leases, and noted that lessors have typically established, and recorded changes to, general operating lease receivable reserves through bad debt expense. [ASU 2018-19 Summary, ASU 2018-19.BC14]

Question 6

How should a lessor record the effect of becoming subject to the collectibility constraint after lease commencement if it maintains a general reserve?

Background: For purposes of this question, consider the following example.

— Lessor LR is the lessor in an operating lease with Lessee LE that has a $100 outstanding lease receivable balance – arising from the straight-lining of lease revenue – at the date LR concludes that collectibility of substantially all the remaining lease payments is not probable.

— LR maintains a general reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.

— Using a systematic and rational approach, LR can determine that $5 of the general reserve is attributable to the lease with LE. To make this determination, LR evaluates its general reserve inclusive and exclusive of the lease with LE.

— LR's assessment of collectibility does not change again during the lease term.

Interpretive response: Based on the technical inquiry with the FASB staff, we believe any one of the following three accounting policies is acceptable.

There is no financial reporting difference between the approaches for a lessor that follows Approach 1 to Question 5 – i.e. records all changes to its general operating lease receivable reserve through lease revenue. Therefore, this response assumes the lessor elects Approach 2 to Question 5 – i.e. records changes to its general reserve through bad debt expense.

Approach 1: Record the effects on a gross basis

The lessor first reserves for the entire outstanding balance of the receivables for the operating lease through a reduction to lease revenue. The lessor then records any necessary change to the general reserve for the effects of removing the troubled lease from the general reserve portfolio through bad debt expense. From the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example to illustrate this approach, at the date LR's assessment of collectibility for the lease changes, LR will recognize:

— a $100 specific reserve for LE's outstanding receivables, offset by a $100 current period reduction to lease revenue; and

— a $5 reduction to the general operating lease receivable reserve, offset by a $5 reduction to current period bad debt expense.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

Approach 2: Record the effects on a net basis

The lessor records a reduction to lease revenue that is *net* of the portion of the general reserve that can be attributed to the lease receivables that are now subject to the collectibility constraint. Consistent with Approach 1, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example to illustrate this approach, at the date LR's assessment of collectibility for the lease changes, LR will:

— reallocate the $5 of the general reserve that can be attributed to the LE lease to a specific reserve for the LE lease; and

— recognize an additional $95 specific reserve for the LE lease, offset by a $95 current period reduction to lease revenue.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

Approach 3: Consider the nature and purpose of the lessor's general reserve

Consistent with Approaches 1 and 2, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

However, under this approach, in contrast to the others, a lessor may *not* record a reduction to lease revenue in the period that the lessor's assessment of collectibility changes. This would be the case if the lessor's general reserve methodology contemplates, and therefore establishes general reserves sufficient to absorb, periodic lease-specific credit impairments (like the background example). In that case, if collectibility of a lease that became subject to the collectibility constraint during the lease term subsequently becomes probable, the remainder of the specific reserve for the lease receivables should be reallocated to the general reserve. The reversal of the specific reserve arising from the collectibility constraint should not result in additional lease revenue or a reduction to bad debt expense, because it was originally established through an allocation from the general reserve.

Determining whether a lessor's general reserves are sufficient to absorb lease-specific credit impairments will likely involve judgment. However, we believe that if the lessor needs to significantly increase its general reserve at or shortly after a lease-specific credit impairment event – to address the risk of non-collection for its remaining population of operating leases not subject to the collectibility constraint – that would be disconfirming evidence to a conclusion that the lessor's general reserve is sufficient to absorb lease-specific credit impairments.

Using the background example to illustrate this approach, assume that LR's general reserve is determined to be sufficient to absorb the LE lease credit impairment. At the date LR's assessment of collectibility for the lease changes, LR will reallocate $100 of the general reserve to a specific reserve for the LE lease; no reduction to lease revenue or additional bad debt expense will be recorded.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

For further information

For more information about lessor accounting for operating leases, refer to Chapter 7 in KPMG's Handbook, Leases.

This document is part of a series to highlight implementation issues related to Topic 842.

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