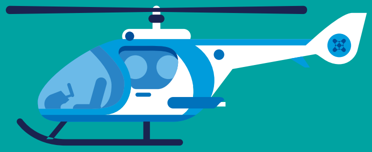
KPMG



Defining Issues®

FASB issues ASU changing lessor accounting

March 5, 2019

KPMG reports on ASU 2019-01,[1] which makes targeted changes to lessor accounting and clarifies interim transition disclosure requirements.

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.
- **Interim period transition disclosures.** All companies adopting ASC 842[3] that have interim reporting requirements.

Key facts and impacts

Fair value of underlying asset. The ASU reinstates the specific fair value guidance in ASC 840[4] 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 reflects any volume or trade discounts, and includes costs incurred to acquire the asset (e.g. sales taxes and delivery and installation costs).

However, if a significant amount of time has elapsed between the asset acquisition date and lease commencement, the fair value would be based on the guidance in ASC 820.[5]

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

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

All lessors present lessee payments received from operating leases as cash flows from operating activities.

Interim period transition disclosures. The ASU clarifies that companies are exempt from making the interim period transition disclosures required by ASC 250[6] for the period in which a change in

[1] ASU 2019-01, Leases (Topic 842): Codification Improvements

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

[3] ASC 842, Leases

[4] ASC 840, Leases

[5] ASC 820, Fair Value Measurement

[6] ASC 250, Accounting Changes and Error Corrections; ASC 250-10-50-3

accounting principle is made as a result of adopting ASC 842.

This interim period disclosure exemption is consistent with the transition guidance in ASC 842,[7] which already allowed companies to exclude the annual effect of the accounting change on income from continuing operations, net income and per-share amounts for periods post-adoption (and prior periods retrospectively adjusted, if using the comparative transition method).

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.[8] 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 provided 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 amendment enacted by ASU 2019-01.[9]

ASU 2016-02[10] eliminated the ASC 820 fair value exception for leases, and the specific fair value guidance for lessors that are not manufacturers or dealers. Before ASU 2019-01, all lessors would have been required to measure the fair value of an underlying asset under ASC 842 based on the exit price notion in ASC 820.

ASU 2019-01 does not reinstate the broad fair value exception in ASC 820 that applied to leases of all lessors and lessees. However, it reinstates the specific fair value guidance from ASC 840 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 others.

These costs form part of the cost basis of the underlying asset. Because of ASC 840's specific fair value guidance, those costs are also included in the fair value of the underlying asset and 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 (pre-ASU 2019-01)

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

Therefore, the costs would not be included in the net investment in the sales-type or direct financing lease, and the lessor's implicit rate would have been higher under ASC 842 than under ASC 840 for the same lease.

The carrying amount of the underlying asset, including the acquisition costs, would be greater than the net investment in the lease. Therefore, for new sales-type or direct financing leases commencing on or after the effective date of ASC 842 lessors 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 ASU 2019-01

Acquisition costs will, once again, generally be included in the measurement of fair value of the underlying asset (if a significant amount of time has not elapsed between asset acquisition and lease commencement).

[7] ASC 842-10-65-1(i)

[8] ASC 820-10-15-2(c)

[9] ASC 840-10-55-44

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

KPMG observation

Therefore, the ASU effectively reverts affected lessors' accounting under ASC 842 to what it was under ASC 840 for underlying asset acquisition costs.

In the ASU's Basis for Conclusions, the FASB explains that it decided to make this change because Board members did not intend to significantly change the accounting for non-manufacturer or dealer lessors in this manner.

The FASB expects affected lessors' accounting for underlying asset acquisition costs will remain consistent with their practice under ASC 840.

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 to be consistent with their treatment of customer payments on loans.

In contrast, ASC 842 (pre-ASU 2019-01) contained explicit guidance on lessor cash flow presentation. It required lessors to present all cash receipts from leases as cash flows from operating activities.[11]

Despite ASC 842's explicit guidance, ASC 942 includes (as it did before ASU 2016-02) 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 was conflicting guidance about how cash receipts should be presented in the statement of cash flows.

ASU 2019-01 amends 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 are required to 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 be acceptable for lessors in the scope of ASC 942 to make 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
- lessee payments in the statement of cash flows consistent with the ASU.

From the ASU's effective date, lessors in the scope of ASC 942 are no longer permitted to elect the option described in the first bullet.

[11] ASC 842-30-45-5

Interim period transition disclosures

ASC 842[12] requires a company to provide all of the transition disclosures required by ASC 250 except for those specifically exempted. Before ASU 2019-01, the only exemption[13] was for the disclosure of the *annual* effect of the change on continuing operations and net income (and affected per share amounts) for the fiscal period in which a change in accounting principle is made. The transition guidance did not exempt companies from similar interim disclosures required by ASC 250.[14]

It was not the FASB's intention to require companies to provide the interim transition disclosures required by ASC 250. Therefore, ASU 2019-01 amends the ASC 842 transition guidance to exempt all companies from ASC 250's interim transition disclosure requirements.

Effective dates and transition

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

All entities are 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 will retrospectively apply the 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).[15]

[12] ASC 842-10-65-1(i)

[13] ASC 250-10-50-1(b)(2)

[14] ASC 250-10-50-3

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

Contributing authors
Scott Muir; Daniel Zamora

KPMG's Financial Reporting View
kpmg.com/us/frv

kpmg.com/socialmedia