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Today's News

FASB News

FASB Proposes to Revise Lease Accounting Rules in Three Areas

Topic(s): FASB, Regulated Industries, Disclosure, Risk, GAAP, IFRS, Financial Reporting, Financial Management

Summary: *As expected, the FASB on October 20, 2020, issued a proposal that would amend lease accounting rules in three areas companies said caused outcomes the rules did not intend or were complex and tricky. Revisions proposed relate to sales-type leases with substantial variable lease payments, remeasurement of a lease liability, and the scope of a lease contract. Companies have until December 4 to submit comments, the board said.*

By Denise Lugo

As expected, the FASB on October 20, 2020, issued a proposal that would amend lease accounting rules in three areas companies said caused outcomes the rules did not intend or were complex and tricky.

The proposal would amend Topic 842, *Leases*, to revise the accounting rules related to sales-type leases with substantial variable lease payments, remeasurement of a lease liability, and the scope of a lease contract.

“The proposed ASU represents our commitment to take timely action based on what we learn during our comprehensive post-implementation review (PIR) process of major standards,” FASB Chair Richard Jones said in a statement. “In this case, it would address three areas brought to our attention by public company stakeholders from their experiences applying the leases standard.”

The proposal comes a year after public companies adopted the rules, and at a time when companies have been rethinking their lease contracts as a result of remote work that was put in place to help stem the spread of COVID-19. If finalized, this will be the sixth round of narrow revisions made to the leases standard since issuance in 2016. The rules were also deferred twice for private companies to 2022.

Companies have until December 4 to submit comments to the potential changes, issued as Proposed Accounting Standards Update (ASU) No. 2020-700, *Leases (Topic 842) Targeted Improvements*.

The FASB voted to issue the proposal in July. (See FASB Agrees to Propose More Amendments to Lease Accounting Rules in the July 30, 2020, edition of *Accounting & Compliance Alert.)*

Curb Loss in Profitable Accounts

The proposal would require sales-type leases with substantial variable payments to be classified and accounted for as operating leases. This change would fix the problem – raised to the FASB by the energy sector – of having to recognize a loss in profit at the start of a lease for accounts that are profitable. “The risk of lessors recognizing losses at lease commencement for sales-type leases that are expected to be profitable would be mitigated and the resulting financial reporting is expected to more faithfully represent the economics underlying the lease,” a summary of the proposal states.

At issue is that in sales-type leases, the lessor is required to remove the property from its books as though it had been sold, i.e., to record a cost in the profit and loss (P&L). However, if the lease payments are variable, Topic 606, *Revenue from Contracts with Customers*, would not permit the lessor to record any net investment in the lease, meaning that there would be no “sale” reported in the P&L when the costs are charged through. Thereafter, any payments received from lessees would be reported as 100 percent revenue, with no offsetting cost.

“The FASB’s proposal would require these types of arrangements be reported as operating leases, which would require that the property remain on the lessor’s books and continue to be depreciated over time, and the lease revenue would similarly be recorded on a straight-line basis over the lease term,” Scott Ehrlich, President of Mind the GAAP, LLC, in West Chester, Pennsylvania, said. “This would result in revenues and costs being reported in the same periods.”

Option Might Prove Challenging

The board also proposed to include an option in the leases standard that permits (but does not require) lessees to remeasure lease liabilities for changes in a reference index or rate affecting future lease payments, consistent with the requirement in IFRS 16, *Leases*. The board said this would eliminate costly and complex differences for financial statement preparers reporting under both GAAP and IFRS standards, but accountants caution the potential for significant system changes.

“While I would argue this would provide better information to financial statement users, I’m not sure lessees are going to be lining up to make this election, as it will likely involve significant system and operational changes,” Ehrlich said. ”However, for lessees that have to comply with both IFRS and U.S. GAAP, making this election would align the accounting between the two frameworks.”

Relief from Modification Rules

The third issue proposed is aimed at providing companies with relief from having to apply lease modification accounting when the lessee has entered into a master lease with the lessor and leases multiple assets under that agreement. Companies have said modification accounting is burdensome because it requires lessees to reevaluate the classification of a lease and reestimate assumptions such as the discount rate, remaining economic life and fair value of the leased asset, etc.

“This amendment could be beneficial for entities impacted by COVID-19 that find themselves needing to reduce current lease agreements due to impact from COVID-19,” Drew Nagus, Assurance and Advisory Principal at Baker Newman Noyes in Woburn, Massachusetts, said.

Currently, if there is a change to a lease that has multiple right of use assets and there is a partial termination of that lease, the entity would be required to apply lease modification guidance which can be complex and require the entity to reassess the entire lease (i.e. classification, right of use asset, lease liability, discount rate, etc.). “The amendment would exempt entities from having to follow lease modification guidance for the remaining lease components within the lease where one or more of the lease components are terminated early as long as is does not economically impact the remaining lease components," Nagus said.

Leases Standard Under Review

Accounting Standards Update ASU No. 2016-02, *Leases (Topic 842)*, was issued to require companies to bring the full magnitude of their long-term lease obligations on the balance sheet. It is one of the most significant new accounting standards published by the board in recent years. The board has made other amendments to the rules.

The rules took effect in 2019 for public companies. In June, the standard was deferred for private companies and not-for-profits by one year to fiscal years beginning after December 15, 2021, and to interim periods within fiscal years beginning after December 15, 2022.

Currently, the guidance is under post-implementation review (PIR), the FASB's process for determining whether a new accounting standard worked as intended.

For in-depth analysis of the FASB's standard for lease accounting, please see Catalyst: US GAAP — Leases , also on Checkpoint.

Additional analysis of the lease standard can be found in the *Accounting and Auditing Update Service*[AAUS] No. 2016-15 and *SEC Accounting and Reporting Update Service*[SARU] No. 2016-13 (March 2016): *Special Report: Accounting for Leases—an Explanation and Analysis of Accounting Standards Update No. 2016-02*.

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