FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2018-20
December 2018

Leases (Topic 842)

Narrow-Scope Improvements for Lessors

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

For additional copies of this Accounting Standards Update and information on applicable prices and discount rates contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Please ask for our Product Code No. ASU2018-20.

FINANCIAL ACCOUNTING SERIES (ISSN 0885-9051) is published monthly with the exception of May and October by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Periodicals postage paid at Norwalk, CT and at additional mailing offices. The full subscription rate is $283 per year. POSTMASTER: Send address changes to Financial Accounting Series, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. | **No. 479**

Accounting Standards Update

No. 2018-20
December 2018

Leases (Topic 842)

Narrow-Scope Improvements for Lessors

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

Accounting Standards Update 2018-20

Leases (Topic 842)

Narrow-Scope Improvements for Lessors

December 2018

CONTENTS

Page Numbers

Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

On February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842),* to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions. The FASB has been assisting stakeholders with implementation questions and issues as organizations prepare to adopt the new lease requirements.

Since the issuance of Update 2016-02, lessor stakeholders have informed the Board about certain issues that they are experiencing on the following when applying Topic 842:

1. Sales taxes and other similar taxes collected from lessees
2. Certain lessor costs
3. Recognition of variable payments for contracts with lease and nonlease components.

Sales Taxes and Other Similar Taxes Collected from Lessees

The guidance in Topic 842 requires lessors to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased or whether those taxes are collected by the lessor on behalf of third parties. When a sales (or other similar) tax is collected from a lessee on behalf of third parties (that is, the lessor is acting as an agent), a lessor excludes that amount from (lease) revenue. When the lessor is primarily obligated for payment of the tax, the lessor accounts for the payment as a lessor cost and includes that amount in (lease) revenue and costs.

Lessor stakeholders observed that evaluating whether sales taxes and other similar taxes are collected on behalf of third parties would be costly and complex because of the number of jurisdictions and the variation of, and changes in, tax laws among those jurisdictions. Those lessor stakeholders also observed that users of financial statements would be provided with limited financial reporting benefits because the net effect of recording those taxes would be zero in the income statement. They also noted that the Board provided stakeholders with relief for a similar requirement in the new revenue guidance in the amendments in Accounting Standards Update No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients,* whereby an entity can make an accounting policy election to exclude amounts collected from customers for all sales (and other similar) taxes from the transaction price.

The amendments in this Update provide an accounting policy election for lessors similar to the accounting policy election provided in the amendments in Update 2016-12.

Certain Lessor Costs

A lessor may incur various costs in its role as a lessor or as owner of the underlying asset (lessor costs). A requirement for the lessee to pay those costs, whether directly to a third party on behalf of the lessor or as a reimbursement to the lessor, does not transfer a good or service to the lessee separately from the right to use the underlying asset. The new leases guidance requires a lessor to report those amounts as revenue and expenses.

Lessor stakeholders observed that reporting certain lessor costs paid by lessees directly to third parties on behalf of the lessor would be costly and complex, and, perhaps, not possible, in many situations. Lessor stakeholders also contended that recording these amounts would provide users of financial statements with limited financial reporting benefits for several reasons. First, because the amounts reported would often be based on estimates that are affected by lessee-specific factors and information that is not readily available to the lessor, the estimated amounts may be unreliable. Consequently, reporting those amounts may not provide users of financial statements with meaningful financial information. Second, because the amounts would be reported as both revenue and expenses by the lessor for the same amount (assuming no profit margin on those costs), the net effect would be zero in the income statement. Those lessor stakeholders also noted that similar application relief was discussed by the Board during deliberations of Accounting Standards Update No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net),* for variable payments when an entity is considered a principal but the uncertainty upon which the variable payments are based is not expected to ultimately be resolved.

The amendments in this Update address stakeholders' concerns about the operability challenges encountered in determining certain lessor costs paid by lessees directly to third parties by requiring lessors to exclude from variable payments, and thus from lease revenue, lessor costs paid by a lessee directly to a third party. The amendments also clarify that costs excluded from the consideration in a contract that are paid directly to a third party by a lessor and reimbursed by the lessee are lessor costs to be accounted for as variable payments.

Recognition of Variable Payments for Contracts with Lease and Nonlease Components

The guidance in paragraph 842-10-15-40 requires lessors to recognize certain variable payment amounts in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur, regardless of whether the payment partially relates to nonlease components.

Some stakeholders observed that this guidance might result in a lessor recognizing revenue for a nonlease component in a period in advance of the period in which the nonlease component is satisfied under another Topic, such as Topic 606, Revenue from Contracts with Customers. Therefore, those stakeholders requested amendments (or clarification) about that paragraph's intent.

The amendments in this Update clarify the accounting by lessors for variable payments that relate to both a lease component and a nonlease component.

Who Is Affected by the Amendments in This Update?

The amendments in this Update related to sales taxes and other similar taxes collected from lessees affect all lessors that elect the accounting policy election.

The amendments in this Update related to lessor costs affect all lessor entities that have lease contracts that either require lessees to pay lessor costs directly to a third party or require lessees to reimburse lessors for costs paid by lessors directly to third parties.

The amendments in this Update related to recognition of variable payments for contracts with lease and nonlease components affect all lessor entities with variable payments that relate to both lease and nonlease components.

What Are the Main Provisions?

Sales Taxes and Other Similar Taxes Collected from Lessees

The amendments in this Update permit lessors, as an accounting policy election, to not evaluate whether certain sales taxes and other similar taxes are lessor costs (as described in paragraph 842-10-15-30(b)) or lessee costs. Instead, those lessors will account for those costs as if they are lessee costs. Consequently, a lessor making this election will exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all collections from lessees of taxes within the scope of the election and will provide certain disclosures.

Certain Lessor Costs

The amendments in this Update related to certain lessor costs require lessors to exclude from variable payments, and therefore revenue, lessor costs paid by lessees directly to third parties. The amendments also require lessors to account for costs excluded from the consideration of a contract that are paid by the lessor and reimbursed by the lessee as variable payments. A lessor will record those reimbursed costs as revenue.

Recognition of Variable Payments for Contracts with Lease and Nonlease Components

The amendments in this Update related to recognizing variable payments for contracts with lease and nonlease components require lessors to *allocate* (rather than *recognize* as currently required) certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease components will be recognized as income in profit or loss in accordance with Topic 842, while the amount of variable payments allocated to nonlease components will be recognized in accordance with other Topics, such as Topic 606.

When Will the Amendments Be Effective?

The amendments in this Update affect the amendments in Update 2016-02, which are not yet effective but can be early adopted. The effective date and transition requirements for the amendments in this Update for entities that have not adopted Topic 842 before the issuance of this Update are the same as the effective date and transition requirements in Update 2016-02 (for example, January 1, 2019, for calendar-year-end public business entities).

For entities that have adopted Topic 842 before the issuance of this Update, the transition and effective date of the amendments in this Update are as follows:

1. An entity should apply the amendments at the original effective date of Topic 842 for the entity. Alternatively, the entity has the option to apply the amendments in either the first reporting period ending after the issuance of this Update (for example, December 31, 2018) or in the first reporting period beginning after the issuance of this Update (for example, January 1, 2019).
2. An entity may apply the amendments either retrospectively or prospectively.

All entities, including early adopters, must apply the amendments in this Update to all new and existing leases.

Amendments to the *FASB Accounting Standards Codification*®

1. The following table provides a summary of the amendments to the Accounting Standards Codification. The amendments are organized by area.

Area	Paragraphs
Issue 1: Sales Taxes and Other Similar Taxes Collected from Lessees	3 and 4
Issue 2: Certain Lessor Costs	5 and 6
Issue 3: Recognition of Variable Payments for Contracts with Lease and Nonlease Components	7

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–10. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Issue 1: Sales Taxes and Other Similar Taxes Collected from Lessees

3. Add paragraph 842-10-15-39A, with a link to transition paragraph 842-10-65-3, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessor

842-10-15-39A A lessor may make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee (for example, sales, use, value added, and some excise taxes). Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset shall be excluded from the scope of this election. A lessor that makes this election shall exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes within the scope of the election and shall comply with the disclosure requirements in paragraph 842-30-50-14.

4. Add paragraph 842-30-50-14 and its related heading, with a link to transition paragraph 842-10-65-3, as follows:

Leases—Lessor

Disclosure

> Separating Components of a Contract

842-30-50-14 A lessor that makes the accounting policy election in paragraph 842-10-15-39A shall disclose its accounting policy election and comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

Issue 2: Certain Lessor Costs

5. Add paragraph 842-10-15-40A, with a link to transition paragraph 842-10-65-3, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessor

842-10-15-40A The guidance in paragraph 842-10-15-40 notwithstanding, a lessor shall exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this requirement does not preclude a lessor from making the accounting policy election in paragraph 842-10-15-39A).

6. Amend paragraphs 842-10-55-141 through 55-142, with a link to transition paragraph 842-10-65-1, as follows:

Implementation Guidance and Illustrations

> Illustrations

> > Illustrations of Allocating Consideration to Components of a Contract

> > > Example 12—Activities or Costs That Are Not Components of a Contract

> > > > Case A—Payments for Taxes and Insurance Are Variable

842-10-55-141 Lessor and Lessee enter into a five-year lease of a building. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy (that is, the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at $10,000 per year, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year.

842-10-55-142 The real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component—the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. However, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized by Lessee in profit or loss in accordance with paragraph 842-20-25-5 or 842-20-25-6. Lessor also recognizes those payments as variable lease payments in accordance with paragraph 842-10-15-40A because the real estate taxes and insurance premiums are paid by Lessor to the taxing jurisdiction and insurance company and reimbursed by Lessee to Lessor. However, if Lessee paid the costs directly to the third parties, those lessor costs would not be recognized by Lessor as variable payments because of the requirement in paragraph 842-10-15-40A.

Issue 3: Recognition of Variable Payments for Contracts with Lease and Nonlease Components

7. Amend paragraphs 842-10-15-40 and 842-10-55-152, with a link to transition paragraph 842-10-65-3, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessor

842-10-15-40 If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall not recognize those payments ~~as income in profit or loss in the period when~~ before the changes in facts and circumstances on which the variable payment is based occur (for example, when the **lessee's** sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).

Implementation Guidance and Illustrations

> Illustrations

> > Illustrations of Allocating Consideration to Components of a Contract

> > > Example 14—Determining the Consideration in the Contract—Variable Payments

> > > > Case A—Variable Payments That Relate to the Lease Component and the Nonlease Component

842-10-55-150 Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (that is, the equipment is not malfunctioning or inoperable). The potential $7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity. The lease is an operating lease.

842-10-55-151 In accordance with paragraph 842-10-15-35, variable payments other than those that depend on an index or a rate are not accounted for as consideration in the contract by Lessee. Therefore, the consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of $100,000 each year (or $300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are $285,000 and $45,000, respectively.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 259,091
Maintenance	45,000	40,909
	$ 330,000	$ 300,000

Each $100,000 annual fixed payment and each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance services). Therefore, annual lease expense, excluding variable expense, is $86,364. Lessee recognizes the expense related to the variable payments in accordance with paragraphs 842-20-25-6 and 842-20-55-1 through 55-2.

842-10-55-152 In accordance with paragraphs 842-10-15-39 through 15-40, Lessor also concludes that the potential variable payments should not be accounted for as consideration in the contract. That is because the potential variable payment each year is not solely related to performance of the nonlease maintenance services; the quality and condition of the underlying asset also substantively affect whether Lessor will earn those amounts. Therefore, Lessor's allocation of the consideration in the contract ($300,000) in this Example is the same as Lessee. Lessor~~, in the same manner as Lessee, also will recognize the income related to~~ will allocate, in accordance with paragraph 842-10-15-40, the variable payments ~~and allocate that income~~ between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), when and if the productivity targets are met ~~earned~~. Lessor will recognize the portion allocated to the lease at that time and will recognize the portion allocated to the nonlease maintenance services in accordance with the guidance on satisfaction of performance obligations in Topic 606 on revenue from contracts with customers.

8. Add paragraph 842-10-65-3 and its related heading, as follows:

Leases—Overall

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*

842-10-65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*:

a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph to all new and existing **leases** when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
b. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall adopt the pending content that links to this paragraph to all new and existing leases at the original effective date of this Topic for that entity as determined in paragraph 842-10-65-1(a) through (b). Alternatively, an entity that has adopted the pending content that links to paragraph 842-10-65-1 may adopt the pending content that links to this paragraph to all new and existing leases either:
    1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
    2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
c. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall apply the pending content that links to this paragraph to all new and existing leases either:

1. Retrospectively to all prior periods beginning with the fiscal years in which the pending content that links to paragraph 842-10-65-1 was initially applied
2. Prospectively.

Amendments to Status Sections

9. Amend paragraph 842-10-00-1, by adding the following items to the table, as follows:

842-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
842-10-15-39A	Added	2018-20	12/10/2018
842-10-15-40	Amended	2018-20	12/10/2018
842-10-15-40A	Added	2018-20	12/10/2018
842-10-55-141	Amended	2018-20	12/10/2018
842-10-55-142	Amended	2018-20	12/10/2018
842-10-55-152	Amended	2018-20	12/10/2018
842-10-65-3	Added	2018-20	12/10/2018

10. Amend paragraph 842-30-00-1, by adding the following item to the table, as follows:

842-30-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
842-30-50-14	Added	2018-20	12/10/2018

The amendments in this Update were adopted by the unanimous vote of the six members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Marsha L. Hunt
R. Harold Schroeder

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. The FASB issued Update 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions. Since the issuance of the new leases standard in February 2016, the FASB has been educating and assisting stakeholders with implementation questions and issues as organizations prepare to adopt the new guidance.

BC3. Some lessor stakeholders have informed the Board about certain issues with the requirements in Topic 842 for the following:

a. Sales taxes and other similar taxes collected from lessees
b. Certain lessor costs
c. Recognition of variable payments for contracts with lease and nonlease components.

BC4. On March 28, 2018, the Board added a project to its technical agenda to address items (a) and (b) above. At its July 25, 2018 meeting, the Board added a project for item (c) above. At that meeting, the Board completed its initial deliberations for all three items. On August 13, 2018, the Board issued proposed Accounting Standards Update, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, for public comment. The Board received 36 comment letters on the proposed Update.

BC5. A discussion of these three issues and the Board's basis for conclusions for addressing those issues are provided below.

Benefits and Costs

BC6. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC7. Overall, the Board concluded that the amendments in this Update simplify the implementation and continued application of Topic 842 by lessors and that the expected cost reduction to present investors justifies the reduction in expected benefits that would accrue to present and potential investors, creditors, donors, and other users.

Basis for Conclusions

Sales Taxes and Other Similar Taxes Collected from Lessees

BC8. Topic 842 requires that a lessor analyze sales (and other similar) tax laws on a jurisdiction-by-jurisdiction basis to determine whether those taxes are lessor costs (as described in paragraph 842-10-15-30(b)) or lessee costs. This analysis is important because it affects how those amounts in the income statement are measured and reported. When a sales (or other similar) tax collected from a lessee is a lessee cost (that is, the lessor is acting as an agent), a lessor would not report that amount in profit or loss. When a sales (or other similar) tax is a lessor cost, the lessor would include any amount collected by the lessor from a lessee for this tax in the measurement of (lease) revenue and costs. This typically would result in recording revenue and expense for the same amount in a lessor's income statement with zero net effect on profit or loss.

BC9. Lessor stakeholders informed the Board about the cost and complexity of assessing tax laws in each jurisdiction. Many entities operate in numerous jurisdictions, and the laws in some jurisdictions are unclear about which party to the transaction is primarily obligated for payment of the taxes. Stakeholders also stated that the variation of, and changes in, tax laws among jurisdictions contributes to that complexity. The challenges may be further complicated for mobile assets for which the lessee controls the location of the leased asset and, therefore, the jurisdictions in which those taxes are assessed. Consequently, some preparers requested that the Board add to Topic 842 an accounting policy election, similar to one already existing in paragraph 606-10-32-2A for sales (and other similar) tax presentation, to reduce the complexity and practical difficulties in assessing whether a tax is collected on behalf of a third party.

BC10. On the basis of stakeholders' feedback, the Board deliberated this issue at its March 28, 2018 meeting and decided to add a project that would provide lessors with an accounting policy election for sales (and other similar) taxes in

Topic 842, consistent with the accounting policy election already existing in Topic 606. The accounting policy election would permit a lessor to elect to exclude from the measurement of (lease) revenue and the associated expense taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. In accordance with the proposal, if a lessor elected to exclude sales taxes and other similar taxes from the measurement of (lease) revenue, the lessor would make that election for all sales (and other similar) taxes within the scope of the policy election.

BC11. In proposing this accounting policy election on sales (and other similar) taxes, the Board recognized that lessors face the same operability issues that led to providing the accounting policy election in paragraph 606-10-32-2A. Therefore, the reasoning to permit a similar accounting policy election for lessors is consistent with the reasoning behind why the Board permitted the accounting policy election in Topic 606. The Board also recognized that permitting a similar accounting policy election would eliminate costs and complexities for lessors in implementing Topic 842 when the financial reporting effect of the requirement is likely to result in no effect to net income. The Board also noted that when a contract includes one or more lease components and one or more nonlease components, it would be counterintuitive that the amounts for sales (and other similar) taxes attributable to the nonlease component(s) are permitted to follow the accounting policy election provided in Topic 606, while the amounts for sales (and other similar) taxes attributable to the lease component(s) would not be not provided with a similar treatment. This outcome would result in additional system implementation challenges and could cause confusion for users of financial statements.

BC12. Almost all respondents to the proposed Update supported the Board's proposal for this accounting policy election. A few respondents questioned why taxes on a lessor's gross receipts were excluded from the election. Because those taxes are levied on a lessor's gross revenue and not a specific lease-producing revenue transaction, the Board concluded that a lessor likely would not be acting as an agent for a lessee with respect to those taxes. Consequently, those taxes should not qualify for the accounting policy election. Rather, taxes on a lessor's gross receipts are more appropriately considered lessor costs and should be accounted for as lease revenue with a corresponding expense. On the basis of the broad support for the accounting policy election and conclusions reached by the Board during its initial deliberations on the issue, the Board finalized the accounting policy election in paragraph 842-10-15-39A.

BC13. Separately, many respondents requested that property taxes be included in this accounting policy election or that a similar accounting policy election be provided for property taxes. The Board considered the feedback in conjunction with feedback received on "Certain Lessor Costs." The Board concluded that an accounting policy election consistent with that provided for sales taxes and other similar taxes collected from lessees for property taxes was unwarranted. The reasons for this decision are discussed in the section below on certain lessor costs.

Certain Lessor Costs

BC14. A lessor may incur various costs in its role as a lessor or as owner of the underlying asset (lessor costs), such as the property taxes and insurance costs illustrated in Example 12—Case A of Subtopic 842-10 (paragraphs 842-10-55-141 through 55-142). A requirement for the lessee to pay those lessor costs does not transfer a good or service to the lessee in addition to the right to use the underlying asset. The new leases guidance, therefore, requires that the lessor report those amounts as revenue and expenses (that is, gross) regardless of whether the lessee pays those lessor costs directly to a third party or as a reimbursement to the lessor.

BC15. When payments made by a lessee directly to a third party for lessor costs (on behalf of the lessor) are variable, those payments are not part of the consideration in the contract and would have been accounted for as variable payments subject to the allocation guidance in Topic 842. That is, the lessor would have allocated those payments to the lease and nonlease components of the contract and recognized the amounts allocated to the lease components in accordance with paragraph 842-10-15-40.

BC16. For certain lessor costs paid directly by lessees to third parties on behalf of the lessor (particularly property taxes and insurance costs related to the leased asset), lessor stakeholders informed the Board about operability challenges in obtaining or otherwise determining those amounts to meet the requirement for including those amounts in the measurement of variable (lease) revenue and related expenses. Lessor stakeholders noted that the costs of complying would be significant and would outweigh the benefits of providing that information primarily because those amounts could be affected by numerous factors, some of which are lessee specific and unknown to the lessor. Determining those amounts often would be challenging and could result in users of financial statements being provided with information that is unreliable. For example, insurance costs paid by a lessee directly to the insurance provider may be affected by numerous factors, some of which are lessee specific, such as deductibles, or when the underlying asset is insured under an umbrella policy.

BC17. Stakeholders requested that the Board provide a practical expedient for lessors to not recognize variable (lease) revenue (and the corresponding cost as an expense) for lessor costs under Topic 842 that are paid directly by the lessee to third parties (Lessee-Paid). Those stakeholders highlighted the following discussions summarized in paragraph BC38(c) of Update 2016-08:

> A key tenet of variable consideration is that at some point the uncertainty in the transaction price ultimately will be resolved. When the uncertainty is not expected to ultimately be resolved, the guidance indicates that the difference between the amount to which the entity is entitled from the intermediary and the amount charged by the intermediary to the end customer is not

variable consideration and, therefore, is not part of the entity's transaction price.

BC18. For consistency, those stakeholders stated that if the Board provides a practical expedient to exclude Lessee-Paid costs for the reasons described in paragraph BC16, then the Board also should consider providing a practical expedient for certain lessor costs when those costs are first paid by the lessor and subsequently reimbursed by the lessee to the lessor (Lessee-Reimbursed). They asserted that the economics between Lessee-Paid and Lessee-Reimbursed costs are the same and, therefore, should not result in different financial reporting outcomes. Those stakeholders noted that a practical expedient on Lessee-Reimbursed costs in addition to a practical expedient on Lessee-Paid costs would provide greater consistency among different types of lease arrangements across different entities, thereby providing more meaningful financial reporting for users of the financial statements to appropriately analyze.

BC19. The Board deliberated those requests and added a project that would require (would not permit as an accounting policy election) that concepts similar to those described in paragraph BC38(c) of Update 2016-08 on variable consideration similarly apply to lessors with variable payments for which there is uncertainty in the amounts of the variable payments and that uncertainty is not expected to ultimately be resolved. Specifically, the Board discussed that a reasoning similar to that described in paragraph BC38(c) of Update 2016-08 should be applied by lessors because leasing is fundamentally a revenue-generating activity for a lessor. In addition, the issue raised in Topic 606 on the requirement to recognize variable consideration for which the uncertainty will ultimately not be resolved also exists in Topic 842.

BC20. The amendments in the proposed Update were not specific about the type of Lessee-Paid costs to which the proposed amendments would apply because it was expected that facts and circumstances would dictate whether there was uncertainty about the amounts and whether that uncertainty was expected to ultimately be resolved. However, at its July 25, 2018 meeting, the Board decided that when a contract is or contains a lease, the uncertainty in the amount of the variable payments would not be expected to ultimately be resolved when the lessor costs paid by the lessee are not *readily determinable* by the lessor. Therefore, the Board proposed a clarification in paragraph 842-10-15-40A that a lessor would exclude from variable payments lessor costs paid by a lessee directly to a third party when the amount of the lessor costs paid by the lessee is not *readily determinable* by the lessor.

BC21. The Board proposed using the term *readily determinable* because guidance in Topic 842 already exists using that term (paragraph 842-20-30-3 requires a lessee to use the rate implicit in the lease whenever that rate is readily determinable) and using that term for Lessee-Paid costs would appear to address the operability challenges raised by lessor stakeholders. The Board concluded that the amount of lessor costs paid by a lessee directly to third parties generally would not be readily determinable by a lessor when those costs are affected by lessee-specific factors (such as insurance costs paid by a lessee directly to an insurance provider when those costs are affected by the policy deductible or when the underlying asset is insured under a broader umbrella policy). The Board expected that a lessor would apply reasonable judgment in determining whether the proposed amendments could be applied to its facts and circumstances.

BC22. Because the Board's intent was to align the basis for the amendments in the proposed Update with the discussion in paragraph BC38(c) of Update 2016-08, the Board did not extend the proposed amendments to Lessee-Reimbursed costs. The Board concluded that the reasoning in paragraph BC38(c) cannot be applied to Lessee-Reimbursed costs because there is no uncertainty about the amount of those costs. Therefore, those amounts were considered readily determinable and, thus, the reimbursements were to be recognized as variable lease payments in accordance with Topic 842. The Board noted that although the economics of an arrangement with Lessee-Paid costs may be very similar to an arrangement with similar terms as Lessee-Reimbursed costs, the main difference between the two arrangements is that the lessor knows the amount of its costs that is reimbursed by the lessee and, thus, the amount of those costs would be readily determinable. Because Topic 842 requires that lessor costs be included as variable lease revenue, the Board concluded that when no uncertainty in those amounts exists, Lessee-Reimbursed costs are lessor costs for which the guidance in Topic 842 should be applied. Extending the request to transactions involving Lessee-Reimbursed costs would have been a significant change in the leases guidance and would not have been supported by the same basis for the Lessee-Paid costs.

BC23. Most respondents to the proposed Update supported the direction of the amendments for Lessee-Paid costs and expressed that the amendments would typically result in Lessee-Paid insurance costs not being accounted for as variable lease payments. The respondents expressed that this was an appropriate conclusion. However, a significant number of lessor respondents were concerned that Lessee-Paid property taxes would be considered readily determinable and, thus, would be required to be estimated and reported as variable lease payments. They asserted that property taxes paid directly by lessees pose challenges for lessors similar to those challenges supporting the accounting policy election for sales taxes and other similar taxes. Specifically, leased assets are located in numerous jurisdictions, and the laws in some jurisdictions may be unclear about which party to the transaction is primarily obligated for payment of the property taxes. They also asserted that determining the amount paid directly by lessees for property taxes is further complicated by the variation of, and changes in, tax laws among jurisdictions and lessee-specific factors. For example, lessees can control the location of certain leased assets, and, therefore, the jurisdictions in which those property taxes are assessed may be unknown to the lessor.

BC24. Along with operability issues for determining Lessee-Paid costs, those respondents indicated that property taxes and insurance costs are typically insignificant to total lease revenue. They also expressed that reporting those costs will generally not have a meaningful effect on financial reporting because the effect on net income would be zero (assuming zero profit margin on those costs). Consequently, they asked that the Board's final guidance not require lessors to estimate those costs. Some respondents suggested that this could be achieved by clarifying that Lessee-Paid property taxes and insurance are not readily determinable.

BC25. Several respondents requested that the Board ensure that both Lessee-Paid property taxes and Lessee-Reimbursed property taxes be excluded from variable payments by either (a) including property taxes in the accounting policy election for sales taxes and other similar taxes or (b) providing a separate accounting policy election. Reasons provided by respondents are consistent with those provided to the Board during its initial deliberations (see paragraph BC18).

BC26. Several respondents, particularly practitioners, asserted that the application of *readily determinable* was inoperable. Although respondents acknowledged that *readily determinable* exists in other areas of GAAP and within Topic 842, they expressed concern that the guidance would be applied inconsistently because of differing interpretations of *readily determinable*. Others requested that the Board provide guidance on how much cost and effort are required for determining whether amounts are *readily determinable*.

BC27. At its October 31, 2018 meeting, the Board considered the feedback received on its proposed Update and deliberated alternatives to address the issues raised by respondents. The Board acknowledged the concerns about estimating costs paid directly by lessees to third parties, particularly the concerns about applying *readily determinable*. The Board also considered whether a separate accounting policy election should be provided for all variable property taxes (Lessee-Paid and Lessee-Reimbursed) whereby a lessor could elect to not account for those taxes as lessor costs.

BC28. The Board decided not to provide a separate accounting policy election for all property taxes, primarily because this election would have allowed a lessor to not account for Lessee-Reimbursed property taxes as variable payments (that is, they would not be accounted for as lessor costs). Although the economics between Lessee-Paid and Lessee-Reimbursed are similar in that both may be costs of the lessor, the Board highlighted that all Lessee-Reimbursed costs are known amounts to the lessor and concluded that those costs should be accounted for as lessor costs. This will result in all Lessee-Reimbursed costs (including property taxes) being reported as revenue with a related expense. The Board clarified in paragraph 842-10-15-40A that "costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments. . . ."

BC29. The Board acknowledged the concerns expressed by lessor respondents that estimating Lessee-Paid costs (particularly property taxes and insurance) would require significant effort to report information that may be unreliable. The Board also noted that reporting those costs as lease revenue with a corresponding expense would have zero effect on net income (assuming zero profit margin on those costs). Additionally, it is the Board's understanding (a) that these amounts are typically insignificant to overall lease revenue and (b) that practice, in most instances, is currently excluding those amounts from lease revenue under Topic 840. Therefore, the Board concluded that excluding all Lessee-Paid costs from being accounted for as variable payments should not be a significant change to current practice.

BC30. The Board agreed that although the term *readily determinable* may be used in Topic 842 for determining the rate implicit in the lease and other areas of GAAP, it may be difficult to apply in the context of determining whether Lessee-Paid costs should be accounted for as variable payments. The Board wanted to eliminate the risk that the amendments in paragraph 842-10-15-40A would be interpreted and applied inconsistently. To alleviate those concerns, the Board decided to remove the term *readily determinable* from the amendments in paragraph 842-10-15-40A. Consequently, lessors will be required, in accordance with paragraph 842-10-15-40A, to exclude from variable payments all Lessee-Paid costs. Thus, those costs will not be reported as lease revenue with a related expense. The Board concluded that this approach is justified on the basis of cost-benefit.

Recognition of Variable Payments for Contracts with Lease and Nonlease Components

BC31. As part of the Board's separate project on Codification improvements to the leases guidance, some stakeholders requested amendments to (or clarifications of) a lessor's accounting for variable payments for contracts with lease and nonlease components when applying paragraph 842-10-15-40 to payments that relate partially to a nonlease component. Specifically, those stakeholders noted that the guidance in paragraph 842-10-15-40 on contracts with lease and nonlease components may result in a lessor recognizing revenue for variable payment amounts allocated to a nonlease component before the period in which the nonlease component is satisfied under another Topic (for example, Topic 606). At its January 24, 2018 meeting, the Board clarified its intent with respect to the application of paragraph 842-10-15-40. Specifically, the Board clarified that after variable payments are allocated between lease and nonlease components under Topic 842, other relevant guidance such as Topic 606 is applied for recognizing the amount allocated to the nonlease component(s).

BC32. At its July 25, 2018 meeting, the Board decided to formalize these clarifications by proposing amendments to paragraph 842-10-15-40. The proposed amendments clarified that variable payment amounts related to lease and nonlease components should not be recognized before the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depend occur). The Board further clarified that when the changes in facts occur, variable payment amounts would then be allocated between the lease and nonlease components. After this allocation, the lease component would be recognized in profit or loss in accordance with Topic 842, while the nonlease component(s) would be recognized in accordance with other Topics (for example, Topic 606).

BC33. Almost all who responded to this issue agreed that the proposed amendments clarify the Board's intent with respect to the application of paragraph 842-10-15-40. One respondent requested that the Board clarify in the amendments that the allocation may not always be on the same basis as the initial allocation of the consideration in the contract or most recent modification not accounted for as a separate contract. This is because paragraph 606-10-32-40 requires specific component allocation if certain criteria are met. Therefore, situations may exist in which the variable payment is allocated entirely to the lease component. The variable payment could not be allocated entirely to the nonlease component in accordance with paragraph 842-10-15-40 because that paragraph deals with variable payments attributable, at least in part, to lease components. Variable payments solely attributable to nonlease components are required to be accounted for in accordance with paragraph 842-10-15-39.

BC34. At its October 31, 2018 meeting, the Board affirmed its decision to amend paragraph 842-10-15-40 to clarify its application. The Board agreed that, in certain circumstances, specific component allocation (after initial allocation) may be warranted to achieve the allocation objective in Topic 606. Therefore, the amendments clarify this by stating that "the allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract *unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s)*" (emphasis added).

Effective Date and Transition

BC35. The amendments in this Update affect the amendments in Update 2016-02, which are not yet effective but can be early adopted. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Update 2016-02, except for an entity that has already adopted Update 2016-02.

BC36. An entity that has adopted Update 2016-02 before the issuance of this Update should apply the amendments in this Update at the original effective date of Topic 842 (for example, January 1, 2018, for calendar-year-end public business entities). Alternatively, the entity has the option to apply the amendments in either the first reporting period ending after the issuance of the Update or the first reporting period beginning after the issuance of this Update. In addition, the entity may apply the amendments either retrospectively or prospectively.

BC37. An entity applying the amendments in this Update should apply the amendments to all leases existing at the date that this Update is initially applied and to new leases entered into after that date.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Those improvements, which will be incorporated into the proposed 2019 Taxonomy, are available through Taxonomy Improvements provided at www.fasb.org, and finalized as part of the annual release process.