Lessors may find that just applying ASC 842’s collectibility guidance is a simpler option than also creating a reserve under ASC 450-20.

What you need to know

- The FASB staff told the Board that it responded to a technical inquiry by saying that lessors can continue to recognize a reserve (i.e., allowance for uncollectible operating lease receivables) under ASC 450-20 after applying the collectibility guidance in ASC 842.

- While electing this option will allow some lessors to continue to maintain a reserve for their portfolio of operating lease receivables, lessors will also have to apply the new collectibility guidance in ASC 842 and write off the receivables related to a particular lease when they determine that all lease payments in the arrangement aren’t collectible.

- We believe that it may be appropriate for a lessor that has data that indicates that collection is not probable under ASC 842 for a portion of its lease population to use a portfolio approach to calculate impairment under ASC 842.

Overview

The staff of the Financial Accounting Standards Board (FASB or Board) told the Board at a public meeting that it responded to a technical inquiry by saying that, under Accounting Standards Codification (ASC) 842, lessors can continue to recognize a reserve for uncollectible operating lease receivables under the loss contingency guidance after applying the collectibility guidance in the new standard.

That is, lessors that choose this option will need to first apply the new collectibility guidance in ASC 842, which requires them to evaluate the collectibility of all lease payments and recognize an impairment for any receivables related to a particular lease if they determine that collection of substantially all of the payments for that lease is not probable.
The staff made the comments in response to questions that arose after the FASB issued final guidance clarifying that receivables related to operating leases are not in the scope of ASC 326, Financial Instruments – Credit Losses, and should instead be accounted for under ASC 842.

Key considerations

ASC 842 requires lessors to evaluate the collectibility of all lease payments. If collection of all operating lease payments, plus any amount necessary to satisfy a residual value guarantee, is not probable (either at lease commencement or after the commencement date), lease income is constrained to the lesser of cash collected or lease income reflected on a straight-line or another systematic basis, plus variable rent when it becomes accruable.

Many lessors, before the adoption of ASC 842, applied ASC 450-20, Contingencies – Loss Contingencies, to recognize reserves for the portion of an operating lease portfolio that, based on historical data, they didn't expect to collect. ASC 842 doesn't address whether a lessor can continue to do this after applying the new standard's collectibility guidance.

Two approaches for accounting for uncollectible lease receivables

At a FASB meeting, the FASB staff described two acceptable approaches to account for uncollectible lease receivables. The staff also said the approach a company elects should be applied consistently and disclosed in the financial statements if the amounts are material.

- **Approach A**: The guidance in ASC 842 is a complete impairment model, and a lessor cannot use other US GAAP (e.g., ASC 450-20) as a basis to recognize a reserve for uncollectible operating lease receivables. Under ASC 842, if collection of all operating lease payments, plus any amount necessary to satisfy a residual value guarantee, is not probable (either at lease commencement or after the commencement date), lease income is constrained to the lesser of cash collected or lease income reflected on a straight-line or another systematic basis, plus variable rent when it becomes accruable.

- **Approach B**: A lessor can record a reserve under ASC 450-20 after applying the guidance in ASC 842. Under ASC 842, if collection of all operating lease payments, plus any amount necessary to satisfy a residual value guarantee, is not probable (either at lease commencement or after the commencement date), lease income is constrained to the lesser of cash collected or lease income reflected on a straight-line or another systematic basis, plus variable rent when it becomes accruable. After completing the ASC 842 assessment, a lessor would apply an ASC 450-20 reserve to the remaining operating lease receivables (i.e., leases that were not impaired under ASC 842). The FASB staff said the accounting for the ASC 450-20 reserve would be consistent with the accounting currently applied for trade receivables (prior to the adoption of ASC 326).

How we see it

A lessor that chooses to establish a reserve under ASC 450-20 will have to apply the guidance in both ASC 450-20 and ASC 842. This may be operationally challenging.

That's because the thresholds for impairment differ. That is, ASC 450-20 requires entities to recognize a charge to income when a loss on a recognized receivable is probable and the amount of the loss can be reasonably estimated, but ASC 842 requires a charge to income when it is not probable that all lease payments in a contract will be collected.
Using the portfolio approach to evaluate collectibility under ASC 842

While we would expect lessors to evaluate whether collection is probable under ASC 842 on a lease-by-lease basis, we note that ASC 842 permits an entity to use a portfolio approach when “the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio.”

We believe that, if a lessor that accounts for its leases on a portfolio basis has data that indicates that collection is not probable under ASC 842 for a portion of its operating lease population, it may be appropriate to apply a portfolio approach to reflect the portion of the population for which collection is not probable (i.e., as an adjustment to lease income). This approach may be applied by a lessor that has many homogeneous operating lease contracts that can be appropriately grouped for the purpose of evaluating whether collection is probable.

As with any application of the portfolio approach, the entity would also need to provide sufficient support for how the impairment is calculated. We note that, under this approach, an entity would be using the portfolio approach to calculate ASC 842 impairment, not an ASC 450-20 reserve.

Endnote:

1 Accounting Standards Update 2018-19, Codification Improvements to Topic 326, Financial Instruments – Credit Losses.