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Assessing the Collectibility of Operating Lease Receivables

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While adopting ASC 842,¹ lessors have raised questions about the appropriate accounting for operating lease receivables recognized by a lessor that are or are expected to become impaired since they are excluded from the scope of the new impairment guidance in ASC 326.² On the basis of a technical inquiry with the FASB staff, we understand the following:

- The application of the guidance in ASC 842-30 requiring an assessment of the probability of an individual customer's (tenant's) future payment is mandatory.
- A lessor may elect to supplement the ASC 842-30 guidance with the use of a general or portfolio reserve approach (aligned with the legacy application of ASC 450-20).
- If a lessor elects to record a general reserve, the income statement impact may be recorded as a reduction to lease income or as bad-debt expense.
- Given the expected diversity in practice, consistent application and transparent disclosure of the policy elected are critical.

Background

In June 2016, the FASB issued [ASU 2016-13](#),³ which adds to U.S. GAAP an impairment model — known as the current expected credit loss (CECL) model — that is based on

¹ For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

² In contrast to operating leases, impairment of a net investment in a lease that is recognized for a lessor with a sales-type or direct financing lease should be accounted for under ASC 326.

³ FASB Accounting Standards Update (ASU) No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

expected losses rather than incurred losses. Once effective, the new guidance will significantly change the accounting for credit impairment under ASC 326.⁴

In November 2018, the FASB issued [ASU 2018-19](#)⁵ to clarify certain aspects of ASU 2016-13, including that operating lease receivables are not within the scope of ASC 326-20. Instead, an entity would need to apply other U.S. GAAP to account for changes in the collectibility assessment for operating leases.

Although ASU 2018-19 amended only ASC 326, which is not effective for calendar-year public business entities until January 1, 2020, we believe that the Board's clarification that operating lease receivables are within the scope of other guidance, namely ASC 842, rather than ASC 326 may result in a change in how some lessors account for the collectibility of operating lease receivables upon the adoption of ASC 842. We understand that there is currently diversity in practice in how some lessors account for credit losses related to operating lease receivables under ASC 840. Specifically, under current practice, certain lessors account for the collectibility of operating lease receivables in a manner consistent with the way they account for the collectibility of trade receivables (i.e., recognize an allowance for uncollectible accounts and a corresponding bad-debt expense), whereas other lessors account for these credit losses as an adjustment to the related lease income.

Operating Lease Collectibility Guidance in ASC 842-30

As discussed above, ASU 2018-19 amended ASC 326-20-15-3 to add ASC 326-20-15-3(g), which states:

The guidance in this Subtopic does not apply to the following items: . . .

- g. Receivables arising from operating leases accounted for in accordance with Topic 842.

In paragraphs BC11 and BC14 of ASU 2018-19, the FASB further explains this scope exception and indicates that ASC 842-30-25-10 through 25-14 "provide a model for assessing the collectibility of operating lease payments."

ASC 842-30-25-12 through 25-14 specifically address the collectibility of operating lease payments as follows:

25-12 If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee or any other unrelated third party) is not probable at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

25-13 If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

25-14 See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements when collectibility is not probable.

⁴ ASC 326 represents a new Codification topic that includes both legacy impairment guidance moved from other Codification sections and new credit loss guidance introduced by ASU 2016-13. In addition, ASU 2016-13 amended some of the legacy guidance moved to ASC 326 from other Codification sections. See Deloitte's June 17, 2016, [Heads Up](#) for more information about the new guidance in ASU 2016-13.

⁵ FASB Accounting Standards Update No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses*.

The following scenario illustrates the lessor's accounting for an operating lease when collectibility is not probable:

ASC 842-30

55-18 Example 1 — Lessor Accounting Example . . .

Case D — Lessor Accounting — Collectibility Is Not Probable

55-40 Assume the same facts and circumstances as Case C (paragraphs 842-30-55-31 through 55-39), except that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is not probable and the lease payments escalate every year over the lease term. Specifically, the lease payment due at the end of Year 1 is \$7,000, and subsequent payments increase by \$1,000 every year for the remainder of the lease term. Because it is not probable that Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party in accordance with paragraph 842-10-25-3, Lessor classifies the lease as an operating lease.

55-41 Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.

55-42 Because collectibility of the lease payments is not probable, Lessor recognizes lease income only when Lessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor only recognizes lease income of \$7,000 at the point in time Lessee makes the end of Year 1 payment for that amount.

55-43 At the end of Year 2, Lessor concludes that collectibility of the remaining lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is probable; therefore, Lessor recognizes lease income of \$12,000. The amount of \$12,000 is the difference between lease income that would have been recognized through the end of Year 2 (\$57,000 in total lease payments ÷ 6 years = \$9,500 per year × 2 years = \$19,000) and the \$7,000 in lease income previously recognized. Collectibility of the remaining lease payments remains probable throughout the remainder of the lease term; therefore, Lessor continues to recognize lease income of \$9,500 each year.

The lessor in the above scenario would have recorded the following lease income (revenue) and straight-line operating lease receivable over the life of the lease:

Year	Lease Payment	Lease Income	Receivable Balance
1	\$ 7,000	\$ 7,000	\$ —*
2	8,000	12,000**	4,000
3	9,000	9,500	4,500
4	10,000	9,500	4,000
5	11,000	9,500	2,500
6	<u>12,000</u>	<u>9,500</u>	<u>—</u>
Total	<u>\$ 57,000</u>	<u>\$ 57,000</u>	

* The receivable balance at the end of year 1 is zero because the lessor concluded that the collectibility of lease payments was not probable; therefore, the lessor recognized lease income equal only to cash received. If the lessor had concluded that collectibility was probable, it would have recognized \$9,500 of lease income and a corresponding \$2,500 receivable.

** The amount of \$12,000 is the difference between lease income that would have been recognized through the end of year 2 (\$57,000 in total lease payments ÷ 6 years = \$9,500 per year × 2 years = \$19,000) and the \$7,000 in lease income previously recognized.

On the basis of the above guidance, the operating lease collectibility model under ASC 842-30 indicates that a lessor must assess whether future operating lease payments are probable of collection. This collection assessment is based on the individual lessees' credit risk as opposed to potential disputed charges. When collectibility of lease payments⁶ is probable, the lessor will apply an accrual model; for example, it will recognize a straight-line lease receivable to ensure ratable recognition of revenue over the lease term. When collectibility is not probable, the lessor will limit lease income to cash received as described above in ASC 842-30-25-13.



Connecting the Dots — Collectibility Assessment of Disputed Charges

Questions have been raised regarding “disputed” charges and whether or in what circumstances “disputed” amounts should be assessed for whether it is probable that the lease payments will be collected. We believe that it would be appropriate for a lessor to first perform an assessment of the “enforceable” lease payments before the assessment of collectibility, in a manner consistent with ASC 606.⁷ That is, first, the lessor evaluates its invoiced amounts to determine whether certain payments may be subject to dispute with its customer (tenant). In circumstances in which it is known, or expected, that all, or some portion, of an invoiced amount will be subject to a future reduction in the amount expected to be collected for the right to use the lessor’s asset, the lessor should consider any adjustment for these items in a manner similar to the accounting for a price concession within the scope of the new revenue standard (see [Section 4.2.5](#) of Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard* for further discussion). Therefore, an evaluation of any future reduction in an invoiced amount should be considered before the assessment in ASC 842-30-25-12 regarding the probability of collection.

The lessor would generally not consider disputed amounts (e.g., a lessee that disputes a variable charge for common area maintenance) in its collectibility assessment under ASC 842 since such disputes would not represent “enforceable” rights in the contract. In a manner consistent with ASC 606-10-25-1(e), the lessor would need to evaluate the disputes before it assesses collectibility. The lessor would then evaluate the customer’s intention and ability to pay promised consideration. As a result, in many cases disputed amounts may not be recognized as a receivable (i.e., there is no enforceable right to cash); this means there is less revenue (lease income) because of the disputed amount.



Q&A 1 Lessor’s Accounting for an Operating Lease When Collectibility Subsequently Becomes Not Probable

Question

Should a lessor follow the guidance in ASC 842-30-25-12 and 25-13 as illustrated in Example 1, Case D, above, if the lessor determines that collectibility is probable at lease commencement but subsequently is no longer probable (i.e., the assessment of probability changes from favorable to unfavorable)?

Answer

Yes. Though the illustrative example above demonstrates a lessor’s accounting for an operating lease when collectibility **is not** probable at lease commencement and subsequently becomes probable, the same principle should be followed in accounting for an operating lease for which the lessor determines that collectibility is probable at lease commencement but subsequently becomes not probable. This is supported by the guidance in ASC 842-30-25-13, which states, “[i]f the assessment of collectibility

⁶ In this publication, references to the “collectibility of lease payments” also should be read to include the collectibility of any residual value guarantees in the contract.

⁷ We believe that the FASB supports this view in paragraph BC102 of FASB Accounting Standards Update No. 2016-02, *Leases*.

changes after the commencement date” (emphasis added). The lessor must apply this guidance regardless of the direction of its change in conclusion about collectibility (i.e., it goes from probable to not probable or not probable to probable).

To demonstrate this accounting, we have used the same facts and circumstances as in Example 1, Case D, except that collectibility of the lease payments⁸ is probable at lease commencement. The lease is classified as an operating lease. In year 1, the lessor will recognize straight-line lease income of \$9,500 (i.e., \$57,000 in total lease payments ÷ 6 years = \$9,500 per year) and will record the cash lease payment of \$7,000 with the remaining as an operating lease receivable of \$2,500 (i.e., \$9,500 of lease income – \$7,000 cash received).

The year 1 journal entry is as follows:

Cash	7,000	
Operating lease receivable	2,500	
Lease income (revenue)		9,500

If, at the end of year 2, the lessor concludes that collectibility of the remaining lease payments **is not** probable, the lessor recognizes lease income of \$5,500 (i.e., the difference between the \$8,000 of cash lease payments received in year 2 and the \$2,500 straight-line receivable balance recorded at the end of year 1). As long as the lessor’s assessment of collectibility remains not probable for the entire lease term, the lessor should record lease income equal to only an amount of cash payments received on a cumulative basis from the lessee.

The lessor in this scenario would have recorded the following lease income and straight-line operating lease receivable over the life of the lease:

Year	Lease Payment	Lease Income	Receivable Balance
1	\$ 7,000	\$ 9,500	\$ 2,500
2	8,000	5,500*	—
3	9,000	9,000	—
4	10,000	10,000	—
5	11,000	11,000	—
6	<u>12,000</u>	<u>12,000</u>	—
Total	<u>\$ 57,000</u>	<u>\$ 57,000</u>	

* The \$5,500 recognized as lease income in year 2 is calculated as cumulative cash received as of the end of year 2 (\$15,000 = \$7,000 + \$8,000) less income already recognized in year 1 (\$9,500) = \$5,500.



Q&A 2 Recognition of a General Allowance for Operating Lease Receivables

Certain lessors recognize an allowance for credit losses (and corresponding bad-debt expense) for billed and straight-line operating lease receivables on the basis of the guidance in ASC 450-20 (on a collective or pooled basis) and ASC 310 (for an individual receivable) when factors indicate that some or all of the balance is no longer collectible. This guidance was amended by the new CECL impairment model in ASC

⁸ For simplicity, this example assumes that there are no residual value guarantees in the contract to consider for probability of collection.

326, and most financial assets subject to the guidance in ASC 450-20 and ASC 310 will be subject to the guidance in ASC 326.

Therefore, questions have arisen about whether an entity can continue to recognize an allowance for credit losses (and corresponding bad-debt expense) for billed operating lease receivables on the basis of the guidance in ASC 450-20 (on a collective or pooled basis).

Question

Can a lessor continue to recognize an allowance for operating lease receivables in which the lessor determined that collectibility is probable?

Answer

Two views have emerged regarding whether, after the adoption of ASC 326, a lessor can continue to recognize an allowance for operating lease receivables for which collectibility is probable. After the adoption of ASC 842, a lessor must apply the guidance in ASC 842-30 as discussed above for any receivable when collectibility is not probable. That is, any valuation reserve accounting method may be used only after an assessment of whether future lease payments are deemed probable of collection. Only if the lease payments over the lease term are deemed probable of collection would the incremental approaches described below be appropriate. If collectibility is not deemed probable, the guidance in ASC 842-30 should be applied, and no lease income should be recognized before cash collection.

On the basis of a technical inquiry with the FASB staff, we believe that either of the approaches described below is acceptable as an accounting policy choice. A lessor should apply its accounting policy consistently and disclose its election.

- *View 1: Record an allowance for operating lease receivables* — In the Background Information and Basis for Conclusions of ASU 2018-19, the FASB explains that ASC 326-20 was not intended to change historical lessor accounting for operating leases:

BC13. The Board noted that the guidance in Topic 842 provides an operational model for determining the collectibility of lease payments that is well understood by lessors. **The Board did not intend to change lessor accounting for operating leases when it issued Update 2016-13.** Therefore, the amendments in this Update clarify that receivables resulting from operating leases accounted for by lessors under Topic 842 are not within the scope of Subtopic 326-20. [Emphasis added]

Therefore, although the amendments in ASU 2018-09 clarify that operating lease receivables are outside the scope of ASC 326-20, it continues to be acceptable for a lessor to apply other U.S. GAAP to ensure that receivables for operating leases for which collectibility of lease payments is probable are not overstated when the lessor does not expect to collect 100 percent of its outstanding receivables.

Under this view, in a manner consistent with the current practice described above, a lessor would recognize an allowance for credit losses (and corresponding bad-debt expense) for billed operating lease receivables in accordance with ASC 450-20. This would generally be calculated on the total portfolio of operating lease receivables for which collectibility is probable. The example below demonstrates the recording of an allowance for operating lease receivables.

Example

Lessor X enters into three leases that are each classified as operating leases for which collectibility of future lease payments⁹ at commencement is probable. For each lease, the term is six years, the lease payment due at the end of year 1 is \$7,000, and subsequent payments increase by \$1,000 every year for the remainder of the lease term. Lessor X will record the lease payments on a straight-line basis to lease income over the life of the lease and establish a corresponding straight-line operating lease receivable.

Further, Lessor X continues to consider whether the operating lease receivables, at a portfolio level, are appropriately valued by using principles that are consistent with those applied under ASC 450-20 (because ASC 326 does not apply) to ensure that its receivables and its income are not overstated. Lessor X has established a policy (on the basis of historical evidence and expectations of future collections) that creates an allowance for 10 percent of all operating lease receivables at the end of each reporting period, recorded as a contra asset. The offset of the 10 percent allowance is recorded to the income statement. (See Q&A 3 below for a discussion regarding presentation in the income statement.)

Lessor X would have recorded the following lease income, straight-line operating lease receivable, allowance for the operating lease receivable, and income statement¹⁰ over the life of the lease (only the first three years of X's entries are shown):

Year	Lease A Payment	Lease B Payment	Lease C Payment	Total	Lease Income	Receivable Balance	Receivable Allowance	Income Statement*
1	\$ 7,000	\$ 7,000	\$ 7,000	\$21,000	\$ 28,500**	\$ 7,500	\$ (750)	\$ 750
2	8,000	8,000	8,000	24,000	28,500	12,000	(1,200)	450
3	9,000	9,000	9,000	27,000	28,500	13,500	(1,350)	150

* See footnote 10.

** Lease income is calculated as the total lease income (\$171,000, or \$57,000 for each lease) divided by six years.

- *View 2: No allowance for operating lease receivables* — As stated above, ASU 2018-19 in other places suggests that ASC 842 may be the sole guidance to apply when an entity is considering the impairment of operating lease receivables after the adoption of ASC 326. Under this view, the Codification will no longer provide a basis for evaluating operating lease receivables under ASC 450-20.

Therefore, on the basis of this interpretation of the amendments in ASU 2018-19, a lessor may elect to not record any allowance for operating lease receivables deemed probable. Operating lease receivables should be adjusted, and will be taken against lease income, only when a lessor specifically identifies a lease (i.e., when the applicable lease collectibility becomes not probable). The lessor will follow the guidance in ASC 842-30-25-12 through 25-14 above to account for changes in collectibility assessments. Under this view, there is no incremental or supplemental general allowance, and no income statement impact as illustrated in View 1 would be recorded.



Q&A 3 Income Statement Classification of General Allowance for Operating Lease Receivables

Question

If an entity establishes an accounting policy to record a general allowance for operating lease receivables (i.e., as in [View 1](#) in Q&A 2), should the allowance be recorded through reductions to lease income (revenue) or through bad-debt expense?

⁹ For simplicity, this example assumes that there are no residual value guarantees in the contract to consider for probability of collection.

¹⁰ See Q&A 3 for a discussion of the income statement classification.

Answer

An entity that records a general allowance on operating lease receivables can record the offset to either lease income or bad-debt expense.

- *Reduction of lease income* — This approach is based on the model established in ASC 842-30 and discussed above. Although the reduction of lease income model in ASC 842-30 is specific to leases for which collectibility is not probable, an entity can follow this same approach and establish an allowance against lease income for expected, but not yet specifically identified, credit issues in the portfolio of leases.
- *Bad-debt expense* — As outlined in View 1 in Q&A 2, in many respects the FASB did not intend to change lessor accounting for operating leases when it issued ASC 326. Under legacy U.S. GAAP, general allowances for operating lease receivables were usually established through bad-debt expense. Therefore, it would be appropriate for an entity to continue the same approach after the adoption of ASC 842 to be consistent with the FASB's statement that entities should continue current practice when recording the general allowance.

Disclosure

On the basis of our discussions with the FASB staff, we understand that the SEC staff is aware of the potential diversity that will exist in practice in this area and has noted that entities should ensure that they apply a consistent policy with transparent disclosures. Disclosure of such an accounting policy is consistent with the guidance in ASC 842-30-50-1, which states, “[t]he objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, **and uncertainty of cash flows** arising from leases” (emphasis added).



Connecting the Dots — Complexities With General Allowances

Although a lessor can establish an accounting policy to record an allowance for operating lease receivables for leases for which collectibility is probable (i.e., as in [View 1](#) in Q&A 2), the lessor should understand that maintaining a general allowance in addition to specifically identifying and accounting for leases for which collectibility is not probable may involve more effort than would applying a policy to adjust operating lease receivables only when collectibility is not probable (i.e., as in [View 2](#) in Q&A 2).

However, if the lessor applies only the ASC 842 collectibility guidance (i.e., as in [View 2](#) in Q&A 2) or establishes a general allowance through a reduction of lease income as described in [Q&A 3](#), it will create inconsistency with the accounting for revenue receivables that are within the scope of ASC 606 and therefore within the scope of ASC 326. Given this inconsistent treatment, if a lessor's leases include nonlease components that are not combined with the lease component under the lessor practical expedient, the lessor will need to apply two separate subsequent-measurement accounting models for contract receivables that contain lease and nonlease (revenue) components.

Additional questions have arisen regarding how an entity that has established an accounting policy of recording an allowance for operating lease receivables through bad-debt expense should account for changes in a collectibility assessment. Specifically, what accounting is required when a receivable that was originally deemed probable of collection and therefore included in the general allowance subsequently becomes not probable of collection (i.e., accounting for the write-off of the operating lease receivable)?

We believe that multiple approaches may be acceptable. When determining the appropriate accounting for changes in collectibility, lessors should consider their policies for establishing the general allowance of operating leases for which collectibility is probable and whether such an allowance contemplated the future write-off of an operating lease receivable within the portfolio of leases. We encourage lessors to consult with their auditors and accounting advisers on this topic.

Looking Ahead

We expect that the FASB staff will discuss these collectibility questions at a future Board meeting, but it is unclear whether the FASB will address the matter through standard setting. However, that is the only avenue by which operating lease receivables can be brought within the scope of ASC 326, and it remains to be seen whether the FASB will reverse its decision in ASU 2018-19. Our views regarding the inclusion of operating lease receivables within the scope of ASC 326 are expressed in our September 19, 2018, [comment letter](#) in response to the FASB's exposure draft on ASU 2018-19.

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