Hot Topic: ASC 842
Understanding the short-term lease exemption

We explore application questions surrounding the short-term lease exemption, and whether or not to elect the exemption.

Key impacts

Under Topic 842, a short-term lease is a lease that, at the commencement date, has a ‘lease term’ of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.\(^1\)

Although short-term leases are in the scope of Topic 842, a simplified form of accounting is permitted. A lessee can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842 and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term. This is how operating leases were accounted for under Topic 840.

A lessee that elects this recognition and measurement exemption must disclose all of the following in its annual financial statements:

— election of the exemption and for which classes of underlying assets it applies;
— lease cost for those leases subject to the exemption with a lease term longer than 30 days; and
— undiscounted short-term lease obligations if that number is significantly different from its short-term lease cost for the most recent annual period.

This Hot Topics explores some reasons why a company may opt not to elect the short-term lease exemption and answers some application questions that companies have raised about the exemption.

Whether to elect the exemption

The exemption permits a company to not recognize short-term leases on its balance sheet, thereby lowering its overall lease liabilities and avoiding certain judgments related to recognition and measurement (e.g. determining a discount rate).

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1. See sections 5.2 and 5.3 of KPMG’s Handbook, *Leases*, for a discussion of ‘reasonably certain’ and the ‘lease term’.
However, a company may decide that not electing the exemption is in its best interest, likely for operational reasons. For example, because of the disclosures required for unrecognized short-term leases, specific processes and controls that are separate and different from those used for the company’s other leases may be needed to account for short-term leases. And if a company has invested in a new leasing IT system or is implementing new processes and controls for its operating leases, it may prefer to run all of its leases, short-term or not, through the same system and processes, particularly if the balance sheet effect of electing versus not electing the exemption is minor.

**Is 12 months a ‘bright line’?**

Companies may have administrative or other reasons (e.g. standard practice or tax reasons) that result in a lease term slightly greater than 12 months (e.g. 367 days). This may be true even when the contract period is intended to approximate one year.

The intent to approximate 12 months notwithstanding, the 12-month threshold for the short-term lease exemption is a bright-line exception to the lessee recognition requirements in Topic 842. As with other exceptions in the accounting literature, it is applied narrowly as written in Topic 842. Consequently, leases whose terms extend beyond one year, even if only by one day, are not eligible for the short-term lease recognition exemption.

**Must a company reassess short-term leases?**

Yes. The requirements for when and how to reassess the lease term or a lessee purchase option for a short-term lease are the same as for all other leases.²

**Lease term with non-consecutive periods of use**

The lease term for a lease may span multiple, non-consecutive periods during an overall contract term that significantly exceeds 12 months in duration. For example, a sports team may have a lease arrangement with the right to use a stadium for 12 days per year (corresponding with the team’s 12 home games each year) for 30 years.

The application questions that have arisen are:

— what is the ‘lease term’; and
— when considering eligibility for the short-term lease exemption, should the sports team consider the total contract duration (30 years) or the lease term (if different from the contract term)?

Assuming there are no lessee renewal options that are reasonably certain to be exercised and no lessor renewal options,³ the lease term is 360 days (12 days × 30 years). When considering eligibility

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². See sections 6.6.1 and 6.6.2 of KPMG’s Handbook, *Leases*, for discussions of (1) when to reassess and (2) accounting for a change arising from a reassessment, respectively.

³. See section 5.3 of KPMG’s Handbook, *Leases*. In addition to the non-cancellable period of the lease, the lease term includes both (1) periods for which the lessee has a renewal option it is reasonably certain to exercise and (2) any periods for which the lessor has an option to extend the lease (regardless of probability of exercise).
for the short-term lease exemption, a lessee considers the lease term, even if that term spans a total
time period greater than one year (in this case, 30 years).

For scenarios that may be similar to the stadium example, to the extent that a short-term lease
extends over a significant period of time (e.g. 30 years) and is material, the disclosure requirement in
paragraph 842-20-50-8 may be triggered. That is, if the short-term lease cost for a material lease in a
year is just a fraction of what the liability would be if recognized (such as might occur in the stadium
example), the lessee would need to disclose that fact and the undiscounted amount of the future
commitment (e.g. for the remaining portion of the lease term for the stadium lease).

**Short-term lease renewals**

Assume a short-term lease with a lease term of 12 months that includes a series of annual lessee
renewal options. It may frequently occur that a lessee will renew the lease at least a few weeks
before the end of the then-current lease term – e.g. the lessee will exercise its renewal option
one month before the end of the current one-year lease term. At that time, the remaining lease term is
13 months. Some companies have questioned whether this circumstance would require the lessee to
abandon short-term lease accounting for that lease.

Topic 842 addresses this scenario. A lessee in a short-term lease only loses eligibility for the short-
term lease exemption if the renewal option is for a period greater than 12 months from the end of the
previously determined lease term. Therefore, in the above example, even though the remaining lease
term at the date of renewal is 13 months, the renewal period does not extend more than 12 months
from the end of the lease term that existed prior to renewal; therefore, the lease continues to be
eligible for the short-term lease exemption.

In contrast, if the renewal period were for a period greater than 12 months or the lessee were to
exercise multiple 12-month renewals (concurrently or during the same then-current 12-month lease
term), the lease would no longer qualify for the short-term lease exemption and would need to be
recognized as of the renewal(s) exercise date.

**Residual value guarantees**

ASU 2016-02 amended Topic 460 (guarantees) so that all lessee guarantees of the residual value of an
underlying asset at the end of the lease term are excluded from the scope of Topic 460 – i.e. there is
no exception to that scoping provision for unrecognized short-term leases.

If a residual value deficiency is probable and estimable in a short-term lease to which the exemption is
being applied, we believe either of the following approaches is appropriate.

— **Recognize the liability immediately.** Under this approach, there is an offsetting entry to prepaid
rent, which is amortized on a straight-line basis over the remainder of the lease term. This
approach is broadly consistent with adding probable residual value deficiencies for recognized
operating or finance leases to the lease liability and the ROU asset; albeit, in this instance, at an
undiscounted amount.

4. See paragraph 842-20-25-3.
5. See section 6.3.1 of KPMG’s Handbook, Leases, for additional discussion on the short-term lease recognition exemption.
6. See paragraph 460-10-15-7(b) and Question 6.3.30 of KPMG’s Handbook, Leases, for discussion on residual value
guarantees in short-term leases.
Accrue the cost over the lease term. Under this approach, the residual value deficiency is an incremental lease payment, recognized on a straight-line basis over the remainder of the lease term so that the expected liability is fully accrued by the time satisfaction of the residual value deficiency is required. This approach is consistent with the FASB’s intent for lessees to account for unrecognized short-term leases in a manner consistent with Topic 840 operating lease accounting.

Effect of past short-term lease renewals on transition

In transition, a lessee that elects the short-term lease exemption for a class of underlying asset will not recognize ROU assets or lease liabilities for short-term leases within that class of underlying asset in transition. Some companies have asked whether renewal history for a lease will preclude its treatment as a short-term lease in transition if they elect the ‘use-of-hindsight’ practical expedient.

Consider an example whereby Lessee LE enters into a lease that commences on January 1, 2017 with a non-cancellable period of 12 months and three 12-month lessee renewal options. On January 1, 2017, it is not reasonably certain that LE will exercise any of the renewal options; therefore, the lease term is 12 months.

As of the effective date (January 1, 2019 for LE), LE has exercised two of the renewal options – i.e. as of the effective date, the current non-cancellable period of the lease extends to December 31, 2019. At no point before exercise was it ever ‘reasonably certain’ that LE would exercise one or more of those options, and it is not reasonably certain at the effective date that LE will exercise its one remaining option to extend the lease to December 31, 2020.7

In this example, LE’s lease qualifies as a short-term lease as of the January 1, 2017 transition date and continues to qualify as a short-term lease at the effective date. This is because, even though with hindsight LE knows that the lease will continue for at least three years from January 1, 2017, the original lease term was only 12 months and no single renewal option LE exercised up to the effective date extended the lease term by more than 12 months from the end of the previously determined lease term.

In contrast, if LE’s lease had an original lease term of 12 months at January 1, 2017, we believe hindsight would preclude characterizing the lease as a short-term lease at January 1, 2017 if LE had exercised:

— a renewal of greater than 12 months at any point before the effective date; or
— more than one of the available 12-month renewal options during the same then-current 12-month lease term.

Other considerations

Companies that elect the short-term lease exemption should be aware of, and prepared to meet, the disclosure requirements that apply for short-term leases subject to the exemption. Those companies should also have adequate processes and controls in place to assess lease term so that only leases eligible for the exemption are not recognized on the balance sheet.

If a company has decided to elect the short-term lease exemption, it should likely disclose that decision in its SAB Topic 11.M (or SAB 74) transition disclosures before the effective date.

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7. See section 5.2 of KPMG’s Handbook, Leases, for discussion of ‘reasonably certain’.
Effective date

Topic 842 is effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2018. It is effective for private companies for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. Early adoption is permitted for all entities.

For further information

For more information about the short-term lease exemption, lease term and the use-of-hindsight transition practical expedient, see section 6.3.1, section 5.3, and section 13.2, respectively, of KPMG’s Handbook, Leases.

See KPMG’s Executive View on transition disclosures to be made under SAB Topic 11.M.

This Hot Topic is part of a series to highlight implementation issues that are discussed in KPMG’s Handbook, Leases.