KPMG

Hot Topic: ASC 842

Fair market rent adjustments

Fair market rent is an index; therefore, lease payments based on fair market rent are variable lease payments that depend on an index or rate.

Key impacts

Lessees and lessors should be aware of the difference between variable lease payments that depend on an index or rate and other variable lease payments. The former are included in the 'lease payments' when determining the initial lease liability and right-of use (ROU) asset; the latter are excluded from the lease payments and are recognized when incurred, and disclosed as variable lease cost.

This difference is important when a lease includes fair market rent adjustments. We believe fair market rent meets the definition of an index. Therefore, payments based on fair market rent are included in the lease payments using the fair market rental rate at lease commencement. Changes to the lessee's payments resulting from changes in fair market rent trigger a remeasurement of the lease only if the lease payments are also required to be remeasured for another reason. Otherwise, the difference between the lease payments based on fair market rent at lease commencement and the lessee's actual, market-adjusted rent payments are accounted for as variable lease payments that do not depend on an index or rate.

Variable lease payments

Topic 842 includes two types of variable lease payments. [842-10-30-5(b), 30-6(a)]

— Variable lease payments that depend on an index or rate (e.g. the CPI, a market interest rate or fair market rent), which are *included* in the lease payments.
— Variable lease payments that do not depend on an index or rate, which are *excluded* from the lease payments.

Variable lease payments that depend on an index or rate are included in the lease payments based on the index or rate at lease commencement. A company does not forecast expected future changes in the index or rate when determining the lease payments; instead, it should assume there will be no changes to the index or rate during the lease term. The amount included in the lease payments (and therefore, the measurement of the ROU asset and the lease liability) will remain unchanged throughout the lease term for changes in the reference index or rate unless one of the events discussed below occurs. [842-10-30-5(b), 35-5]

Fair market rent is an index

Some leases stipulate that the lessee's payments will be adjusted to (or based on) fair market rent periodically after lease commencement. For example, a lease may include fixed payments for Years 1–5 of a 10-year term, but specify that the lease payments for Years 6–10 will be adjusted to fair market rent at the beginning of Year 6.

While Topic 842 does not specifically identify fair market rent as an index, we believe it meets the definition of an index. We further note that the FASB and the IASB reached converged decisions on measuring the lease payments at lease commencement, and IFRS 16 explicitly states that 'payments that vary to reflect changes in market rental rates' are variable lease payments that depend on an index or rate. Payments equal to fair market rent at lease commencement are included in the initial measurement of the lease payments. [IFRS 16.28]

Remeasuring lease payments for a change in fair market rent

Under Topic 842, a lessee remeasures variable lease payments based on an index or rate, including those based on fair market rent, only if there is: [842-10-35-5]

- a modification of the lease that is not accounted for as a separate contract; or
- a remeasurement of the lease for a reason unrelated to the change in the reference index or rate – e.g. there is a change in the lease term or in the amount probable of being owed under a residual value guarantee.

A *lessor* remeasures variable lease payments that depend on an index or rate only if the lease is modified and that modification is not accounted for as a separate contract. A lessor accounts for each of the following as lease modifications that are not separate contracts. [842-10-35-3, 35-6]

- A lessee exercises an option to renew/extend a lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise.
- A lessee exercises an option to terminate a lease that the lessor previously determined the lessee was reasonably certain not to exercise.

When a company (lessee or lessor) remeasures variable lease payments that depend on an index or rate, it uses the index or rate as of the date of remeasurement. [842-10-35-5]

IFRS 16 and Topic 842 differ about when a lessee remeasures variable lease payments that depend on an index or rate. Unlike Topic 842, under IFRS 16, a lessee's variable lease payments that depend on an index or rate are remeasured when the change in the lease payments resulting from the index or rate change takes effect. [IFRS 16.42(b), BC190]

Example:
Calculating lease payments when they adjust to fair market rent

Lessee LE enters into a building lease with Lessor LR for 10 years, with an option to renew the lease for an additional five years. LE will pay $100 per year for the first five years, an annual amount for Years 6–10 based on market rent at the beginning of Year 6, and an annual amount for Years 11–15 based on market rent at the beginning of Year 11. Fair market rent at lease commencement is $100/year.

In addition, the following facts are relevant.

- The lease term is 10 years at lease commencement because LE is not reasonably certain to exercise the renewal option.
- There are no initial direct costs or lease incentives.
- At the beginning of Year 6, market rent is $110/year.
- At the beginning of Year 11, market rent is $120/year.
- There are no performance- or usage-based variable lease payments.
- The lease is classified as an operating lease.

Scenario 1: No reassessment or modification occurs

There is no modification or reassessment event that would require remeasurement of the lease (e.g. a change in the lease term or in the amount probable of being owed under a residual value guarantee) during the 10-year lease term.

At lease commencement, LE and LR measure the lease payments as follows.

Period	Amount	Calculation
Years 1–5	$ 500	$100/year (fixed)
Years 6–10	500	5 years × $100/year market rent at lease commencement
Total	**$ 1,000**	

LE (LR) recognizes straight-line operating lease cost (income) of $100/year during Years 1–5. There is no variable lease cost.

At the beginning of Year 6, the annual rental payment adjusts to the fair market rent of $110/year for Years 6–10. However, because there is no modification of the lease or reassessment event that would otherwise require its remeasurement, LE and LR do not remeasure the lease payments for the change in the annual payment amount from $100 to $110.

Instead, LE's lease liability continues to be based on five remaining annual payments of $100, and its straight-line (i.e. non-variable) operating lease cost for Years 6–10 remains $100/year. LR's straight-line operating lease income for Years 6–10 also remains $100/year. The incremental rent of $10/year resulting from the change in fair market rent is treated as variable lease cost (income) in each of Years 6–10.

Scenario 2: Lessee LE elects the renewal option

Assume the same facts as Scenario 1, except that at the beginning of Year 7 LE notifies LR that it will elect the five-year renewal option. LE and LR both account for this as a change in the lease term that triggers a remeasurement of the lease.

At the remeasurement date (beginning of Year 7), LE and LR remeasure the remaining lease payments as follows.

Period	Amount	Calculation
Years 7–10	$ 440	$110/year (fixed after the Year 6 market rent adjustment)
Years 11–15	550	5 years × $110/year market rent at beginning of Year 7
Total	**$ 990**	

LE (LR) recognizes straight-line operating lease cost (income) of $110/year during Years 7–10. There is no variable lease cost (income).

At the beginning of Year 11, the annual rental payment adjusts to the fair market rent of $120/year for Years 11–15. However, because there is no modification of the lease or reassessment event that would otherwise require remeasurement of the lease at that time, LE and LR do not remeasure the lease payments for the change in the annual payment amount from $110 to $120.

Instead, LE's lease liability continues to be based on five remaining annual payments of $110, and its straight-line (i.e. non-variable) operating lease cost for Years 11–15 remains $110/year. LR's straight-line operating lease income for Years 11–15 remains $110/year. The incremental rent of $10/year resulting from the change in fair market rent at the beginning of Year 11 is treated as variable lease cost (income) in each of Years 11–15.

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 accounting for variable lease payments in Topic 842, including fair market rent adjustments, see section 5.4.1 of KPMG's Handbook, Leases. For more information on lessee reassessments, lessee modifications and lessor modifications, see section 6.6, section 6.7 and section 7.6, respectively.

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