FASB issues ASU

Change to Topic 842 ends Lessor Day 1 losses from variable lease payments

July 19, 2021

Lessors to classify leases with variable payments as operating if another classification would trigger a Day 1 loss.

Applicability

ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments

Applies to all companies and not-for-profit entities.

Fast facts, impacts, actions

Under Topic 842 (pre-ASU), a lease with variable payments could give rise to a commencement date selling loss (Day 1 loss) if classified as sales-type or direct financing. This is because the net investment in the lease excludes expected variable lease payments that do not depend on an index or rate. Consequently, the initial net investment in the lease may be less than the carrying amount of the underlying asset derecognized at lease commencement. That difference would create a Day 1 loss. This accounting results even if the lessor expects that the arrangement will be profitable over the lease term.

To avoid this accounting result, the FASB issued ASU 2021-05. This ASU requires a lessor to classify a lease with entirely or partially variable payments that do not depend on an index or rate as an operating lease if another classification (i.e. sales-type or direct financing) would trigger a Day 1 loss.

This means the lessor will not derecognize the underlying asset or record a Day 1 loss, and variable lease revenue earned and recognized over the lease term will be partially offset in income each period of the lease term by the underlying asset's depreciation instead of being recognized at a 100% gross margin.

The ASU may be early adopted (see Effective dates and transition) and applies to all companies and not-for-profit entities.

Action: Lessors with arrangements giving rise to these Day 1 losses – principally arrangements with a significant portion of the total payments being variable – will likely welcome this ASU to avoid the uneconomic result of sales-type lease classification.

Lessors reporting under Topic 842 and eager to adopt the amendments may do so immediately. Lessors must also consider whether they want to adopt the amendments retrospectively or prospectively.

Background

It is common in certain industries for a lease to be comprised primarily, or even entirely, of variable lease payments. Despite this, these types of leases can meet one or more of the criteria for sales-type lease classification if, for example, (1) the lease term is for a major part of the underlying asset's remaining economic life or (2) the asset is of a specialized nature.

A Day 1 loss may result for such leases and, less commonly, sales-type or direct financing leases with a smaller variable payment element. This is because the lessor's net investment in the lease excludes the expected variable payments. Therefore, the commencement date carrying amount of the underlying asset may exceed the initial measurement of the net investment, resulting in a Day 1 loss in the amount of that difference.

Lessors communicated to the Board that recognizing a Day 1 loss does not properly reflect the economics of these leases when they are expected, as is typically the case, to be profitable overall. In addition, the accounting resulting from sales-type or direct financing classification for these leases also leads to recognizing a significantly inflated margin on the variable lease revenue earned over the lease term. Stakeholders observed that this is not representationally faithful because it is principally just a recovery of the Day 1 loss. A significant portion of that margin results from the underlying asset no longer being recorded on the lessor's books.

Further, lessors observed that they generally did not recognize a Day 1 loss on leases of this nature under legacy US GAAP (Topic 840). Lessors and practitioners generally interpreted Topic 840 to require those leases to be classified as operating leases. However, the classification criterion on which that interpretation was based was not included in Topic 842.

Stakeholders, particularly in the utilities industry, asked the FASB to amend Topic 842 to better reflect the economics of these lease arrangements.

Observation: The Board has been aware of this lessor Day 1 loss issue since first issuing Topic 842, and previously considered whether to address the issue by requiring lessors to estimate variable payments for these leases (or more broadly). However, the Board concluded that retaining a simpler lessor accounting model that does not require estimating variable lease payments, even in limited circumstances, was more important than avoiding upfront losses for leases with variable payments.

The Board considered this approach of estimating variable payments again during its deliberations of ASU 2021-05. The Board acknowledged that it was superior conceptually to that adopted in the ASU, but rejected it again on the grounds that it would (1) be inconsistent with how lessees account for variable lease payments and (2) introduce unnecessary costs and complexity for lessors as compared to the ASU approach.

Final amendment

The amendment to Topic 842 in ASU 2021-05 resolves the Day 1 loss issue described above (see Background). It requires lessors to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease if:

— the lease would have been classified as a sales-type lease or a direct financing lease under the pre-ASU classification criteria; and

— sales-type or direct financing classification would result in a Day 1 loss.

Observation: Leases that will now be classified as operating leases as a result of ASU 2021-05 may now qualify for the lessor practical expedient to not separate lease and associated non-lease components (see section 4.4.1 of KPMG Handbook, Leases).

Because the amendments only apply to lessors, some finance leases of lessees will now be classified as operating leases by the lessor. Previously, the criteria for finance and sales-type lease classification were aligned. It will now be possible that some sale-leaseback transactions will fail for the seller-lessee (because the leaseback would be classified as a finance lease), but not for the buyer-lessor (for whom the leaseback may still be classified as an operating lease).

Example 1: Lessor accounting – Impact of variable lease payments

Background

Lessor LR enters into a contract with Lessee LE to lease a non-specialized machine for five years. The contract is structured so that payments from LE to LR related to use of the underlying asset are based entirely on LE's use of the machine. These facts are relevant at the lease commencement date.

Variable lease payments:	3% of LE's monthly sales of units produced using the machine
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of machine:	$40,000
Carrying amount of machine:	$36,000
Lease term:	5 years
Remaining economic life of machine:	6 years
Estimated future residual value:	$12,500
Residual value guarantee:	None

LR is unable to calculate a rate implicit in the lease that is greater than zero because the sum of (1) the lease payments ($0, because the lease payments are variable) and (2) the estimated residual value of the machine at the end of the lease term ($12,500) is less than the machine's fair value at the lease commencement date.

Classification and initial measurement

Scenario 1: Before adopting ASU 2021-05

The lease is a sales-type lease because the lease term of five years represents a major part (83%) of the machine's remaining economic life.

Therefore, LR uses a 0% discount rate and records a Day 1 loss as follows.

	Debit	*Credit*
Unguaranteed residual asset[1]	12,500	
Loss[2]	23,500	
PP&E – machine		36,000
To recognize unguaranteed residual asset and upfront loss and derecognize underlying asset at lease commencement date.		

Notes:

1. Estimated future residual value ($12,500) discounted at 0%.
2. Calculated as the sum of (1) lease payments ($0) and (2) any prepaid lease payments ($0) – the net of (1) the carrying amount of the machine ($36,000) and (2) the unguaranteed residual asset ($12,500).

Scenario 2: After adopting ASU 2021-05

Although the lease still meets the lease term sales-type lease criterion, sales-type classification would result in the lessor recognizing a Day 1 loss because of the lease's variable payments (see Scenario 1). Therefore, consistent with paragraph 842-10-25-3A, LR classifies the lease as an operating lease.

As an operating lease, LR continues to recognize the machine and depreciate it over its useful life. LR records the variable lease payments (the only payments for the lease under the contract) as revenue in the period(s) in which the sales of units produced using the machine occur.

Effective dates and transition

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2021	December 15, 2021
Interim periods – Fiscal years beginning after	December 15, 2021	December 15, 2022
Early adoption permitted?	Yes, but not before adopting Topic 842	

The available transition approaches depend on the entity's Topic 842 adoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021-05).

— **Lessors that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-05 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see chapters 13A and 13B of KPMG Handbook, Leases, respectively).

— **Lessors that have already adopted Topic 842** will apply the amendments in ASU 2021-05 either:

- retrospectively to leases that commenced or were modified on or after the entity's adoption of Topic 842 (e.g. on January 1, 2019 for a calendar-year public business entity); or
- prospectively to leases that commence or are modified (and that modification is not accounted for as a separate contract) after the entity adopts the ASU 2021-05 amendments.

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