

Hot Topic: ASC 842

Penalties and termination rights



Beware of the broad concept of a penalty under Topic 842 when considering the effect of termination rights on the lease term.

Key impacts

Under Topic 842, the ‘lease term’ excludes periods after which both the lessee and the lessor have the unilateral right to terminate the lease, without permission from the other party and with no more than an insignificant ‘penalty’. This is because, after both parties’ termination rights become exercisable, neither party has enforceable rights (i.e. the lessee to use the underlying asset, or the lessor to receive lease payments) or obligations (i.e. the lessee to make lease payments, or the lessor to permit continued use of the underlying asset). [\[842-10-55-23\]](#)

This means that if a lessee and a lessor each have the unilateral right to terminate a lease at the end of Year 2 of a stated five-year term with no more than an insignificant penalty, the Topic 842 ‘lease term’ cannot exceed two years – regardless of how likely it is that both parties will decide to extend the lease beyond the end of Year 2.¹

But what constitutes a penalty, and what are the implications of changes in the assessment of whether a penalty is ‘more than insignificant’?

‘Penalty’ is a defined term in Topic 842, carried forward from Topic 840, with a broad meaning. It encompasses economic penalties beyond any requirement for the terminating party to make a cash payment to the other party. Lessees and lessors need to consider the broad definition of a penalty when assessing whether both the lessee and the lessor have the right to terminate the lease with no more than an insignificant penalty. [\[842 Glossary ‘Penalty’\]](#)

Incorrect conclusions on this point can result in:

- inaccurate measurement of lease assets and liabilities;
- incorrect lease classification; and/or
- for lessees, incorrect conclusions about eligibility for the short-term lease exemption.²

1. See section 5.3 of KPMG’s Handbook, [Leases](#).
2. See section 6.3.1 of KPMG’s Handbook, [Leases](#).



Termination right with a more-than-insignificant penalty

Definition of penalty

'Penalty' is defined in Topic 842 as follows.

Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:

- a. Disburse cash
- b. Incur or assume a liability
- c. Perform services
- d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:
 1. The uniqueness of purpose or location of the underlying asset
 2. The availability of a comparable replacement asset
 3. The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers
 4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset
 5. Adverse tax consequences
 6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the underlying asset at market rental rates or to tolerate other parties using the underlying asset.

Significance of a penalty may change over time

A penalty may expire or, over a period of time, the effect of a penalty that is initially more than insignificant may become insignificant. For example, a termination penalty that is more than insignificant if exercised after only one year of a lease may be insignificant after two or three years when considered in the context of the entire arrangement (see example below).

Both lessee and lessor have termination rights with no more than an insignificant penalty

The lease term does not extend beyond the point when the unilateral termination rights of both the lessee and lessor become exercisable. The lease term includes any required notice period. For example, if both parties can exercise a termination option at the end of one year, but a one-month notice period is required (i.e. the lease terminates one month after the option is exercised), the lease term is 13 months.

Both lessee and lessor have termination rights – lessor's termination right gives rise to a more-than-insignificant penalty; lessee's does not

When the lessor's termination right becomes exercisable at the same time as or after the lessee's termination option, the lease term is the shorter of the period from lease commencement until:

- a. the *lessor's* exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. the *lessee's* termination option becomes exercisable *plus* any periods after that for which the lessee is reasonably certain not to exercise the option.

In contrast, if the lessor's termination right will no longer result in a more-than-insignificant penalty *before* the lessee's termination option becomes exercisable, the lessor-only termination option is disregarded for accounting purposes until the lessee's termination option becomes exercisable. When the lessee's termination option becomes exercisable, both the lessee and the lessor have the unilateral

right to terminate the lease with no more than an insignificant penalty, and the lease term does not extend beyond that point. [842-10-30-1(c)]

Observation

Given the similarity between (1) what constitutes a penalty and (2) the factors in Topic 842 that could create a compelling economic reason for a lessee to renew (or not terminate) a lease, we generally would not expect (b) above to include periods after the lessee's termination option becomes exercisable. We believe the absence of a more-than-insignificant penalty generally means that the lessee is not reasonably certain to extend the lease beyond the date its termination option (that does not result in a more-than-insignificant penalty) becomes exercisable. [842 Glossary 'Penalty', 842-10-55-26]

Both lessee and lessor have termination rights – lessee's termination right gives rise to a more-than-insignificant penalty; lessor's does not

When the lessee's termination right results in a more-than-insignificant penalty, regardless of when the lessor's termination right becomes exercisable, the lease term is the shorter of the period from lease commencement until:

- a. the lessee's exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. the lessee's termination option becomes exercisable (without regard to the penalty) *plus* any periods after that for which the lessee is reasonably certain not to exercise its termination option.

Observation

As a practical matter, we believe there should be little, if any, difference between (a) and (b) above. This is because 'reasonably certain' is a high threshold of probability – i.e. intended to capture situations in which the lessee is effectively compelled economically (has little or no choice but) to exercise an option. [ASU 2016-02.BC197]

Given the similarity between (1) what constitutes a penalty and (2) the factors in Topic 842 that could create a compelling economic reason for a lessee to renew (or not terminate) a lease, we would not expect a company to conclude *both* that: [842 Glossary 'Penalty', 842-10-55-26]

- the lessee is reasonably certain to extend (i.e. not terminate) the lease; and
- terminating the lease will result in no or only an insignificant penalty.

In other words, we believe it will generally be the case that (b) is equal to or shorter than (a), and therefore it will generally not be necessary for a company to calculate both (a) and (b).

Example



Termination rights

Scenario 1: Lessee and lessor both have right to terminate – lessee's termination right gives rise to a more-than-insignificant penalty; lessor's does not

Lessee LE and Lessor LR enter into a lease, granting LE the right to use LR's equipment for a non-cancellable period of one year. After one year, the lease will continue for up to four additional years (five years in total) unless cancelled by either party. The lease payments are fixed, and those payments are considered to be at-market at lease commencement.

Each party has the unilateral right to terminate the contract at the end of Years 1–4 by providing notice to the other party at least 30 days before the end of the then-current year. If LE terminates the contract, LE must pay to transport the equipment back to LR’s location.

In addition, the following facts are relevant.

- Equivalent pieces of equipment are readily available for lease from other suppliers at a similar rental price and subject to similar contractual terms and conditions.
- The equipment must be installed before use. Installation costs are incurred each time a new piece of equipment is installed and the installation is a significant undertaking.
- The transportation costs LE will incur to return the equipment to LR are substantial because of the location of LE’s operations and the nature of the equipment.
- LE’s operations depend on using this type of equipment.
- LE’s operations will necessarily halt for a period of at least a few days if it needs or chooses to switch equipment units. The shut-down will result in lost production revenue and non-productive idle time costs related to LE’s operating crew. These shut-down costs are substantial.
- The total of the expected additional installation, transportation and shut-down costs would be significant when compared to the annual lease payment.

Although LE and LR each have the unilateral right to terminate the lease at the end of Year 1, LE cannot do so without incurring a penalty. Based on the definition of ‘penalty’, if it chooses to terminate the lease with LR, LE will incur a penalty comprising:

- additional installation costs LE will incur to install replacement equipment – i.e. LE needs equipment of this nature for its operations; therefore, additional installation costs constitute an economic detriment to LE that would not be incurred if LE simply continued its lease with LR;
- transportation costs LE will incur to ship LR’s equipment back to LR’s location; and
- shut-down costs incurred while the equipment is being uninstalled and replaced – i.e. LE could avoid the shut-down costs by continuing its lease with LR.

Based on the expected significance of the penalty that would result, LE does not have the right to terminate the lease without a more-than-insignificant penalty at the end of Year 1. Therefore, only LR has an option to terminate the lease at the end of Year 1 without a more-than-insignificant penalty, while LE has no similar option until *at least* the end of Year 2.

Consequently, the lease term is the shorter of the period from lease commencement until:

- a. LE’s exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. LE’s termination option becomes exercisable (without regard to the penalty) *plus* any periods after that for which LE is reasonably certain not to exercise its termination option.

With respect to (a), we know that period is *at least* two years. Similarly, the significance of the penalty and the short one-year period until the termination option becomes exercisable (without regard to penalty) mean that LE is reasonably certain not to terminate the lease until *at least* the end of Year 2.

Additional facts that are not provided would be needed to determine the actual lease term (i.e. whether the lease term is two years or a longer period). These include the following: the expected amount of the installation, transportation and shut-down costs; the annual lease payment amount; and expectations about the productivity of the equipment in the future – e.g. expectations about whether the equipment will decline in productivity and/or incur significant operational down-time as it ages, or that technological developments will reduce the desirability of the equipment to LE.

Scenario 2: Lessee and lessor both have right to terminate with no more than an insignificant penalty

Assume the same facts as Scenario 1, except that:

- the equipment does not require significant installation efforts;

- transportation costs to return the equipment to LR are minor; and
- because there is no significant installation process, idle time incurred in switching the units is short.

Therefore, unlike in Scenario 1, LE's termination option at the end of Year 1 does not give rise to a more-than-insignificant penalty, and the non-cancellable period of the lease and the lease term are both one year.

- LE has no:
 - right to extend the lease beyond the end of Year 1 because LR has the right to terminate the lease at the end of Year 1 without a more-than-insignificant penalty; or
 - obligation to make lease payments beyond the end of Year 1 because it can terminate the lease without incurring a more-than-insignificant penalty.
- LR has no:
 - right to receive lease payments (i.e. by requiring LE to extend the lease) beyond the end of Year 1 because LE has the right to terminate the lease at the end of Year 1 without a more-than-insignificant penalty; or
 - obligation to extend LE's right to use the underlying asset beyond the end of Year 1 because it can terminate the lease without incurring a more-than-insignificant penalty.



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 lease term requirements in Topic 842, see sections 5.2 and 5.3 of KPMG's Handbook, [Leases](#).

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

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