

To the Point

FASB – final guidance

FASB amends lessor classification guidance to prevent selling losses on leases with variable payments

The amendments address an issue identified during the Board's post-implementation review process.

What you need to know

- ▶ The FASB amended ASC 842 to require lessors to classify leases as operating leases if they have variable lease payments that do not depend on an index or rate and would have selling losses if they were classified as sales-type or direct financing leases.
- ▶ Lessors that have adopted ASC 842 as of 19 July 2021, when the amendments were issued, can apply the amendments either retrospectively to leases that commenced or were modified on or after the date of adoption of ASC 842 or prospectively to leases that commence or are modified on or after the date the amendments are first applied.
- ▶ For lessors that have adopted ASC 842 as of 19 July 2021, the amendments are effective for annual periods beginning after 15 December 2021 and interim periods either within those years or within the following year, depending on when they were required to adopt ASC 842. Early adoption is permitted.
- ▶ Entities that have not adopted ASC 842 as of 19 July 2021 are required to apply the amendments when they adopt ASC 842 and follow the transition requirements in ASC 842.

Overview

The Financial Accounting Standards Board (FASB or Board) **amended**¹ Accounting Standards Codification (ASC) 842, *Leases*, to require lessors to classify leases as operating leases if they have variable lease payments that do not depend on an index or rate and would result in selling losses if they were classified as sales-type or direct financing leases.

The amendments address concerns stakeholders raised during the FASB's post-implementation review that recognizing an immediate loss for these leases, as required under ASC 842 in certain cases, does not appropriately represent the underlying economics at lease commencement.

The stakeholders pointed out that an immediate loss can result if a lessor classifies a lease with variable lease payments that are not based on an index or rate as a sales-type or direct financing lease, even if the contract is expected to be profitable. That's because the lessor is required to exclude variable lease payments that do not depend on an index or a rate from its initial recognition of its net investment in the lease. And without those payments, the net investment in the lease a lessor initially recognizes may be less than the carrying value of the underlying asset that the lessor derecognizes, resulting in a selling loss at lease commencement. The amendments will prevent that from happening because lessors don't recognize a net investment in the lease or derecognize an asset for operating leases.

Key considerations

The new guidance applies only to lessors and requires them to classify leases with variable lease payments that are not based on an index or rate (e.g., long-term leases of machinery where the consideration in the contracts is determined based on hours used by the lessee) as operating leases if they would have otherwise been classified as sales-type or direct financing leases and the lessor would have recognized a selling loss at lease commencement.

The amendments don't change how variable lease payments are recognized. That is, variable lease payments that are not based on an index or rate would still be recognized as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

As a lessor applies the amendments, it should keep in mind that it must also determine whether the underlying asset is impaired prior to lease commencement (e.g., by applying the impairment guidance in ASC 360, *Property, Plant, and Equipment*). For example, if the selling loss that would be avoided by applying the amendments results from reasons other than just the variable lease payments (e.g., total expected lease payments, including the expected variable lease payments, are less than the carrying amount of the underlying asset), that would be an indicator under ASC 360 that the underlying asset is impaired before the lease commences.

How we see it

The requirement to classify more leases as operating leases may expand the population of leases that qualify for the practical expedient that allows a lessor to combine lease and nonlease components and account for them as a single component because the scope of the expedient is limited to operating leases.

It may also result in more sale and leaseback transactions being accounted for as successful purchases of the asset by buyer-lessors (not seller-lessees). That is because the guidance on sale and leaseback transactions considers classification to determine whether the transaction is accounted for as a successful sale (e.g., classification by the buyer-lessor as a sales-type lease automatically results in a failed sale and leaseback, while classification as an operating lease does not).

Transition and effective date

Lessors that have adopted ASC 842 as of 19 July 2021

Lessors that have adopted ASC 842 as of 19 July 2021, the date the amendments were issued, can apply the amendments either retrospectively to leases that commenced or were modified on or after the date of adoption of ASC 842 or prospectively to leases that commence or are modified on or after the date the amendments are first applied.

A lessor that applies the amendments retrospectively should apply the amendments to leases that commenced or were modified on or after the date of adoption of ASC 842 and not on or after the date of initial application of ASC 842 (e.g., a lessor that adopted ASC 842 on 1 January 2019 would apply the amendments to leases that commenced or were modified on or after that date regardless of whether it applied ASC 842 as of the earliest period presented).

Lessors that apply the guidance retrospectively are required to provide certain disclosures required by ASC 250, *Accounting Changes and Error Corrections*. Lessors that apply the guidance prospectively are required to disclose the nature of and reason for the change in accounting principle, the transition method applied and a qualitative description of the financial statement line items affected by the change.

For lessors that are (1) public business entities; (2) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market; and (3) employee benefit plans that file or furnish financial statements with or to the Securities and Exchange Commission, the amendments are effective for annual reporting periods beginning after 15 December 2021 and interim periods within these annual reporting periods. The guidance is effective for all other entities that have adopted ASC 842 as of 19 July 2021 for annual reporting periods beginning after 15 December 2021 and for interim periods within annual reporting periods beginning after 15 December 2022. Early adoption is permitted.

We believe a lessor may early adopt the amendments retrospectively in any period for which the financial statements have not been issued. We also believe it would be acceptable for a lessor to early adopt the amendments prospectively for (1) any leases that commenced or were modified on or after 19 July 2021 or (2) any leases that commenced or were modified on or after the beginning of any period for which the financial statements have not been issued (e.g., 1 July 2021 for financial statements for the interim period ending 30 September 2021).

Lessors that have not adopted ASC 842 as of 19 July 2021

Lessors that have not adopted ASC 842 as of 19 July 2021 are required to apply the amendments when they adopt ASC 842 and follow the transition requirements in ASC 842. As a reminder, for these entities, ASC 842 is effective for annual reporting periods beginning after 15 December 2021 and interim periods in annual reporting periods beginning after 15 December 2022.

Endnote:

¹ Accounting Standards Update 2021-05, *Leases (Topic 842): Lessors – Certain Leases with Variable Lease Payments*.