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FASB Makes Targeted Improvements to Leasing Guidance for Lessors With Leases Containing Variable Lease Payments

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Background

On July 19, 2021, the FASB issued [ASU 2021-05](#),¹ which requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate (hereafter referred to as “variable payments”) as an operating lease on the commencement date of the lease if specified criteria are met.

Before the release of the ASU, sales-type leases or direct financing leases with significant variable payments may have resulted in a day 1 loss on the arrangement even if the overall economics of the arrangement were expected to be profitable. This is because, under ASC 842,² variable payments are excluded from the definition of lease payments for both lessees and lessors. Accordingly, lessors exclude variable payments when measuring the net investment in the lease. As a result, the recognition of the net investment in the lease may be less than the derecognition of the underlying asset. The example below illustrates this concept.

¹ FASB Accounting Standards Update (ASU) No. 2021-05, *Lessors — Certain Leases With Variable Lease Payments*.

² FASB Accounting Standards Codification (ASC) Topic 842, *Leases*.

Example

Assume that a company is entering into a 20-year power purchase agreement under which a customer is required to take all electricity produced by a facility and all payments are variable (since the customer pays on the basis of actual production). The carrying value of the facility is \$10 million just before the commencement of the arrangement, and the present value of the expected residual asset value is \$500,000. Because it is involved in the design of the facility, the customer controls the right to direct the use of the asset. The results of the useful-life test reveal that the lease of the facility meets the sales-type lease classification criteria. The resulting accounting at lease commencement would yield a day 1 loss for the arrangement, as indicated in the following journal entries:

Net investment in lease	500,000	
Day 1 loss	9,500,000	
Facility (PP&E)		10,000,000

The FASB issued ASU 2021-05 to address the uneconomic outcome illustrated above. This amendment only affects lessor accounting and will have no impact on lessees.

Key Provisions of the ASU

ASU 2021-05 adds ASC 842-10-25-3A as a new paragraph. This new guidance requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease at lease commencement if:

1. The lease would have been classified as a sales-type lease or direct financing lease in accordance with the classification criteria in ASC 842-10-25-2 and 25-3, respectively.
2. The lessor would have recognized a selling loss at lease commencement.

When applying the guidance in ASC 842-10-25-3A, the lessor would not derecognize the underlying asset upon lease commencement but would continue to depreciate the underlying asset over its useful life. Further, in accordance with ASC 842-30-25-11, the lessor would recognize fixed lease payments as “income . . . over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset.” Variable lease payments would be recognized as “income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur,” as indicated in ASC 842-30-25-11(b).

Note that the ASU does not prescribe a threshold for the amount of variable payments; for an entity to apply the ASU’s guidance, a lease only needs to contain some amount of variable payments.



Connecting the Dots

As a result of ASU 2021-05, we expect more lessors to classify leases as operating leases as opposed to sales-type leases or direct financing leases. Accordingly, additional leases will qualify for the lessor practical expedient in ASC 842-10-15-42A,³ which allows lessors to combine lease and nonlease components into a single component if certain scope requirements are met. One such requirement is that the

³ ASC 842-10-15-42A, as amended by ASU 2021-05, states, “As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A.”

underlying lease component must be classified as an operating lease. Therefore, as a result of the ASU, additional leases will qualify for the lessor practical expedient.

Effective Date and Transition

For entities that have not adopted ASC 842 on or before July 19, 2021, lessors should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-05. An entity should adopt the ASU on the same date on which it adopts ASC 842.

Lessors that have adopted ASC 842 as of July 19, 2021, should apply the transition requirements below for fiscal years beginning after December 15, 2021.⁴ The amendments in ASU 2021-05 should be applied by using either of the following approaches:

1. Retrospective application to leases that commence or are modified on or after the adoption of ASC 842, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).
2. Prospective application to leases that commence or are modified on or after the date on which a lessor first applies the amendments in ASU 2021-05, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).

Early adoption of ASU 2021-05 is permitted, as long as the adoption of this ASU does not occur before the adoption of ASC 842.

⁴ For public business entities and entities within the scope of ASC 842-10-65-1(a), this ASU should be applied for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other entities within the scope of ASC 842-10-65-1(b), this ASU should be applied for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

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