KPMG

Executive Summary

Topic 842, *Leases* – Lessees

December 2021

Topic 842 focuses on increased transparency and comparability – providing financial statement users with more information about an entity’s leasing activities.

In a snapshot

The FASB’s new leases standard (Topic 842) has been adopted by all *public* companies and public not-for-profit entities reporting under US GAAP. Meanwhile, the mandatory effective date for all other entities is rapidly approaching.

Under Topic 842, lessees recognize all leases, including operating leases, with a term greater than 12 months on-balance sheet. In addition, lessees disclose key information about their leasing transactions.

	Balance sheet	Income statement	Statement of cash flows
Finance leases	✓	✓	✓
	Substantially the same as capital lease accounting under Topic 840		
Operating leases	⚠	✓	✓
	Recognized on-balance sheet	Substantially the same as operating lease accounting under Topic 840	

Key balance sheet measures and ratios may change, affecting analyst expectations and potentially compliance with contractual covenants.

IT systems may need to be upgraded or modified to ensure all leases are captured and the lease data necessary to apply Topic 842 are accumulated.

Accounting processes and/or internal controls will need to be revised to apply Topic 842, which requires significant new judgments and reassessments during the lease term.

Effective dates

	Public business entities[1]	Other types of entities
When is Topic 842 effective?	Annual and interim periods in fiscal years beginning after December 15, 2018	— Annual periods in fiscal years beginning after December 15, 2021 — Interim periods in fiscal years beginning after December 15, 2022
Can entities early adopt?	Yes, all entities can adopt Topic 842 immediately	

Note 1: For public not-for-profit entities (i.e. those that have issued or are a conduit bond obligor for securities that are traded, listed or quoted on an exchange or an over-the-counter market), Topic 842 is effective for annual and interim periods in fiscal years beginning after December 15, 2019.

The transition approach

Modified retrospective transition approach with the cumulative effect of application recognized at either the:

- beginning of the earliest comparative period presented – comparative periods adjusted; or
- effective date – comparative periods not adjusted.

Certain practical expedients are permitted.

- Package of practical expedients (must be elected together). At the adoption date, an entity may elect not to reassess:
  - whether expired or existing contracts contain leases under the Topic 842 definition of a lease;
  - lease classification for expired or existing leases; and
  - whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.
- Use of hindsight – when determining the lease term and in assessing other lease options.
- Not to reassess whether land easements not accounted for as leases under Topic 840 qualify as leases under Topic 842.

Practical expedients must be applied consistently to all leases for which the entity is a lessee or a lessor.

Leases on-balance sheet

A lessee will recognize all leases with a term greater than 12 months on its balance sheet.

A lessee will recognize a right-of-use (ROU) asset and a lease liability for all leases, including operating leases, with a term greater than 12 months, which may significantly increase reported assets and liabilities for some lessees.

The critical accounting determination will be whether a contract contains a lease. The lease classification distinction will affect how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet as it does under Topic 840.

Lease liability initial and subsequent measurement

Lease liability = **Present value of unpaid lease payments**

Lease payments exclude variable or contingent payments other than those that are in-substance fixed.

The discount rate for the lease is the lessor's implicit rate if it is readily determinable; otherwise, it is the lessee's incremental borrowing rate. When the rate implicit in the lease is not readily determinable, a lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, instead of its incremental borrowing rate, as an accounting policy election by class of underlying asset.

ROU asset initial measurement

Lease liability + **Initial direct costs** + **Prepaid lease payments** – **Lease incentives received**

Topic 842 has a narrow definition of initial direct costs. Some origination costs incurred in negotiating and arranging a lease that were capitalized under Topic 840 will now be expensed when incurred.

ROU asset subsequent measurement[1]

Finance lease

ROU asset = **Beginning balance** – **Accumulated amortization***

* The ROU asset is amortized generally on a straight-line basis over the lease term.

Operating lease

There are two methods, each of which yields the same carrying amount throughout the lease term.[2]

Method 1. The amortization of the ROU asset each period equals the difference between the straight-line single lease cost for the period and the periodic accretion of the lease liability using the effective interest method.

ROU asset = **Beginning balance** – **Accumulated amortization**

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1 ROU assets (finance and operating) are subject to the long-lived asset impairment guidance (Topic 360).

2 Under both methods, if a ROU asset becomes impaired, subsequent measurement is the same as for a finance lease.

Method 2. The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period. This is inherently a manual process.

Lease liability + Unamortized initial direct costs ± Prepaid (accrued) lease payments – Unamortized balance of lease incentives received

Other key considerations

Lease and non-lease components

Topic 842 only governs the accounting for leases.

— If there are lease and non-lease components (e.g. consumables or services), an entity applies the new standard to the lease components and other US GAAP to the non-lease components, unless a lessee elects (by class of underlying asset) to account for non-lease components as part of the lease component to which they relate.

Contract consideration allocated between the lease and non-lease components.

— The consideration in the contract is allocated to the lease and non-lease components on a relative stand-alone price basis, maximizing the use of observable information.

— Likewise, variable payments are also allocated to the lease and non-lease components on a relative stand-alone price basis. Variable payments are allocated to both the lease and non-lease components, regardless of their nature.

No more 'executory costs'.

— Maintenance is a non-lease component – i.e. a service provided to the lessee.

— Lessee payments of lessor tax and insurance costs, whether paid to the lessor or directly to a third party (e.g. a taxing authority or insurance company) are not payments for non-lease components. Fixed or variable payments of such amounts are allocated to the lease and non-lease components in the same manner as all other payments in the contract, and, therefore, will not be excluded from lease accounting as they are under Topic 840.

Short-term leases

Lessees may elect, by class of underlying asset, not to recognize leases with a 'lease term' of 12 months or less on balance sheet, provided the lessee does not have a bargain purchase option.

— Short-term leases are accounted for in the same manner as operating leases under Topic 840 except that they are subject to the new reassessment and remeasurement requirements that apply to all other leases.

— The 'lease term' includes any optional renewal periods the lessee is 'reasonably certain' to exercise.

— '12 months or less' is a bright-line threshold; leases with a term even slightly greater (e.g. 367 days) do not qualify.

More frequent revisions to lease accounting will require new processes and controls

A lease liability is remeasured when:	The lease term and purchase options are reassessed when:
— The lease is modified and that modification is not accounted for as a separate contract. — There is a change in the assessment of: - the lease term; or - a purchase option being exercised. — There is a change in the amount probable of being owed under a RVG. — A contingency is resolved that results in some or all variable lease payments becoming fixed payments.	— There is a significant event or significant change in circumstances that is within the lessee's control and directly affects the assessment of whether the lessee is reasonably certain to exercise an option (extension, termination, purchase). — The lessee elects to exercise an option even though the entity has previously determined that the lessee was not reasonably certain to do so – or vice versa.

Sale-leaseback accounting substantially changed

Topic 842 eliminates sale-leaseback accounting as an off-balance sheet financing proposition. This is because seller-lessees will recognize a ROU asset and a lease liability for the leaseback.

— If a sale-leaseback transaction does not qualify as a sale under the revenue recognition guidance, the seller-lessee will account for the failed sale as a financing transaction.

— Sale and capital (finance) leasebacks will no longer exist. A finance leaseback will result in a failed sale.

— Repurchase options will preclude sale accounting if the asset is real estate. For all other assets, repurchase options will preclude sale accounting unless (a) the strike price of the repurchase option is the fair value of the asset at the option exercise date and (b) there are substantially equivalent assets readily available in the marketplace.

— If the sale-leaseback transaction qualifies as a sale, the seller-lessee will recognize the entire gain from the sale (i.e. the difference between the selling price and the carrying amount of the underlying asset) at the time of sale rather than over the leaseback term (as typically occurred under Topic 840). An exception arises if the selling price is not 'at-market'. If the selling price is above market, the above market amount is additional financing to the seller-lessee, and if the selling price is below market, the below market amount is accounted for as prepaid rent.

The current build-to-suit lease guidance is replaced

Topic 842 eliminates the current build-to-suit lease accounting guidance and, instead, stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date.

— The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period. This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback guidance.

— The changes to the sale-leaseback guidance generally make it easier for lessees to remove real estate assets recognized during the construction period from their balance sheets.

— The transition provisions of Topic 842 will result in many entities derecognizing build-to-suit assets and liabilities that have remained on the balance sheet after the end of the construction period under Topic 840.

Expanded qualitative and quantitative disclosures

The disclosure objective of Topic 842 is to provide financial statement users sufficient information to assess the amount, timing and uncertainty of cash flows arising from leases.

To achieve that objective, a lessee's disclosures will include:

— **Qualitative** disclosures, such as information about the nature of leases (e.g. terms and conditions of variable lease payments, extension and termination options, purchase options, and residual value guarantees).

— **Quantitative** disclosures, such as operating lease cost, amortization of finance lease ROU assets and interest on finance lease liabilities, variable lease cost, short-term lease cost, weighted-average remaining lease term, weighted-average discount rate, and a maturity analysis of lease liabilities.

— Significant judgments and assumptions made, such as whether a contract contains a lease, stand-alone prices for lease and non-lease components, and the discount rate for the entity's leases.

KPMG Handbook, Leases explains Topic 842 in detail, using Q&As, examples and observations, and comparing the requirements to Topic 840.

KPMG Leases Hot Topics series highlight hot button issues related to Topic 842 for lessees and lessors.

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