Hot Topic: ASC 842

Understanding the short-term lease exemption

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We explore application questions surrounding the short-term lease exemption, and whether or not to elect the exemption.

Key impacts

Under the new leases standard (Topic 842) a short-term lease is a lease that, at the commencement date, has a 'lease term' of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.[1]

Although short-term leases are in the scope of Topic 842, a simplified form of accounting is permitted. A *lessee* can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842 and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term. This is how operating leases are accounted for under legacy US GAAP (Topic 840). A lessee that elects this recognition and measurement exemption must disclose all of the following in its annual financial statements:

— election of the exemption and for which classes of underlying assets it applies;
— lease cost for those leases subject to the exemption with a lease term longer than 30 days; and
— undiscounted short-term lease obligations if that number is significantly different from its short-term lease cost for the most recent annual period.
— This Hot Topic explores some reasons why an entity may opt not to elect the short-term lease exemption and answers some application questions that have been raised about the exemption.

Whether to elect the exemption

The exemption permits an entity to not recognize short-term leases on its balance sheet, thus lowering its overall lease liabilities and avoiding certain judgments related to recognition and measurement (e.g. determining a discount rate).

However, an entity may decide that not electing the exemption is in its best interest, likely for operational reasons. For example, because of the disclosures required for unrecognized short-term leases, specific processes and controls that are separate and different from those used for the entity's other leases may be needed to account for short-term leases. And if an entity has invested in a new leasing IT system or is implementing new processes and controls for its operating leases, it may prefer

1. See sections 5.2 and 5.3 of KPMG Handbook, Leases for discussions of 'reasonably certain' and the 'lease term', respectively.

to run all of its leases, short-term or not, through the same system and processes, particularly if the balance sheet effect of electing or not electing the exemption is minor.

Is 12 months a 'bright line'?

Entities may have administrative or other reasons (e.g. standard practice or tax reasons) that result in a 'lease term' slightly greater than 12 months (e.g. 367 days). This may be true even when the contract period is intended to approximate one year.

The intent to approximate 12 months notwithstanding, the 12-month threshold for the short-term lease exemption is a bright-line exception to the lessee recognition requirements in Topic 842. As with other exceptions in the accounting literature, it is applied narrowly as written in Topic 842. Consequently, leases whose terms extend beyond one year, even if only by one day, are not eligible for the short-term lease recognition exemption.

Must I reassess short-term leases?

Yes. The requirements for when and how to reassess the lease term or a lessee purchase option for a short-term lease are the same as for all other leases.[2]

Lease term with non-consecutive periods of use

The 'lease term' for a lease may span multiple, non-consecutive periods during an overall contract term that significantly exceeds 12 months in duration. For example, a sports team may have a lease arrangement whereby it has the right to use a stadium for 12 days per year (corresponding with the team's 12 home games each year) for 30 years. The application questions that have arisen are:

- what is the 'lease term'; and
- when considering eligibility for the short-term lease exemption, should the sports team consider the total contract duration (30 years) or the lease term (if different from the contract term).

Assuming there are no lessee renewal options that are reasonably certain to be exercised and no lessor renewal options,[3] the lease term is 360 days (12 days × 30 years). When considering eligibility for the short-term lease exemption, a lessee considers the lease term, even if that term spans a total time period greater than one year (in this case, 30 years).

For scenarios that may be similar to the stadium example, it is important to note that to the extent a short-term lease extends over a significant period of time, such as 30 years, and is material, the disclosure requirement in paragraph 842-20-50-8 may be triggered. That is, if the short-term lease cost for a material lease in a year is just a fraction of what the liability would be if recognized (such as might

2. See sections 6.6.1 and 6.6.2 of KPMG Handbook, Leases for discussions of (1) when to reassess and (2) how to account for a change arising from a reassessment, respectively.
3. See section 5.3 of KPMG Handbook, Leases. In addition to the non-cancellable period of the lease, the lease term includes both (1) periods for which the lessee has a renewal option it is reasonably certain to exercise and (2) any periods for which the lessor has an option to extend the lease (regardless of probability of exercise).

occur in the stadium example), the lessee would need to disclose that fact and the undiscounted amount of the future commitment (e.g. for the remaining portion of the lease term for the stadium lease).

Notice periods

When either the lessee or lessor has the right to terminate a lease at any time by giving notice to the other party, the non-cancellable period of the lease includes the 'notice' period.

For example, a lease agreement may grant each party the unilateral right to terminate the lease, for any reason and without penalty, by giving 90 days' notice to the other party. This means that at any point in time before such notice is given by either party, enforceable rights and obligations for both parties exist for 90 days. Therefore, at lease commencement, and until either party gives formal notice of its intent to terminate the lease, the non-cancellable period of the lease is 90 days.[4]

Entities should ensure that they appropriately consider the effect of termination notice periods on the lease term before concluding that the lease qualifies as a short-term lease.

Short-term lease renewals

Assume a short-term lease with a 'lease term' of 12 months that includes a series of annual lessee renewal options. It may frequently occur that a lessee will renew the lease at least a few weeks before the end of the then-current lease term (e.g. the lessee will exercise its renewal option one month before the end of the current one-year lease term). At that time, the remaining lease term is 13 months. Some entities have questioned whether this circumstance would require the lessee to abandon short-term lease accounting for that lease.

Topic 842 addresses this scenario.[5] A lessee in a short-term lease only loses eligibility for the short-term lease exemption if the renewal option is for a period greater than 12 months from the end of the previously determined lease term. Therefore, in the above example, even though the remaining lease term at the date of renewal is 13 months, the renewal period does not extend more than 12 months from the end of the lease term that existed prior to renewal so the lease continues to be eligible for the short-term lease exemption. In contrast, if the renewal period were for a period greater than 12 months or the lessee were to exercise multiple 12-month renewals (concurrently or during the same then-current 12-month lease term), the lease would no longer qualify for the short-term lease exemption and would need to be recognized as of the renewal(s) exercise date.[6]

Evergreen leases

An 'evergreen' lease is one that automatically renews until one party – either the lessee or lessor – terminates it. Because evergreen leases generally have no fixed contractual end date, questions

4. See Q&A 5.3.20 of KPMG Handbook, Leases for discussion on the effect of termination notice clauses on the non-cancellable period.
5. See paragraph 842-20-25-3.
6. See section 6.3.1 of KPMG Handbook, Leases for additional discussion on the short-term lease recognition exemption.

frequently arise in practice about how to determine the lease term and whether these leases qualify for the short-term lease exemption.

In defining a 'short term lease' the FASB considered that many evergreen leases (i.e. those on a day-to-day, week-to-week, month-to-month or year-to-year basis) would meet that definition. However, to qualify for the short-term lease exemption and to determine whether the disclosure requirements for short-term lease costs apply (see 'Key impacts'), lessees must assess the lease term for the lease.

The lease term for evergreen leases is established in the same manner as for all other leases under Topic 842, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options. This determination may involve significant judgment. We believe that, in general, the shorter the non-cancellable period of a lease, the greater likelihood that the lessee is reasonably certain to exercise one or more lease term renewal options. This is because, in many cases, it may be cost prohibitive to continually substitute leased assets.

For example, consider a lease that has no stated term and no notice period (see 'Notice periods' above) but requires Lessee LE (1) to pay a fixed fee to Lessor LR for the right to use the underlying asset and (2) to return the asset to LR when it no longer has use for it. In this scenario, the non-cancellable period of the lease is one day. This is because LE can elect to return the asset to LR before the start of Day 2.

Next, LE and LR must consider whether LE is reasonably certain to continue to use the asset beyond the one-day non-cancellable period. Unless LE is reasonably certain to continue the lease beyond the first day, the lease term is only one day.

We believe that the extremely short non-cancellable period, one day in this example, will influence the determination of whether LE is reasonably certain to renew the lease beyond the non-cancellable period. The costs to LE for terminating the lease (e.g. returning the asset to LR's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract and training employees to use a different asset) may provide a compelling economic reason for LE to continue to use the same asset for a period that is longer than the non-cancellable period. Therefore, the lease term likely exceeds, and may *far* exceed, the one-day non-cancellable period. If the lease term exceeds 12 months, the evergreen lease is not a short-term lease. [7]

Residual value guarantees

ASU 2016-02 amended Topic 460, Guarantees, so that all lessee guarantees of the residual value of an underlying asset at the end of the lease term are excluded from the scope of Topic 460 – i.e. there is no exception to that scoping provision for unrecognized short-term leases.[8]

If a residual value deficiency is probable and estimable in a short-term lease to which the exemption is being applied, we believe either of the following approaches is appropriate.

- **Recognize the liability immediately.** Under this approach, there is an offsetting entry to prepaid rent, which is amortized on a straight-line basis over the remainder of the lease term. This approach is broadly consistent with adding probable residual value deficiencies for recognized operating or finance leases to the lease liability and the ROU asset (albeit, in this instance, at an undiscounted amount).
- **Accrue the cost over the lease term.** Under this approach, the residual value deficiency is an incremental lease payment, recognized on a straight-line basis over the remainder of the lease

7. See example 5.3.30 and the Observation that follows of KPMG Handbook, Leases for discussion of evergreen leases.
8. See paragraph 460-10-15-7(b) and Q&A 6.3.30 of KPMG Handbook, Leases for discussion on residual value guarantees in short-term leases.

term so that the expected liability is fully accrued by the time satisfaction of the residual value deficiency is required. This approach is consistent with the Board's intent for lessees to account for unrecognized short-term leases in a manner consistent with Topic 840 operating lease accounting because it is consistent with the legacy requirements in Topic 840 for when payment of a residual value deficiency becomes probable in an operating lease.

Effect of past short-term lease renewals on transition

In transition, a lessee that elects the short-term lease exemption for a class of underlying asset will not recognize ROU assets or lease liabilities for short-term leases within that class of underlying asset in transition.

Some entities that considered adopting both the short-term lease exemption and the 'use-of-hindsight' transition practical expedient asked whether renewal history for a lease will preclude its treatment as a short-term lease in transition. Consider an example whereby Lessee LE enters into a lease that commences on January 1, 2020 with a non-cancellable period of 12 months and three 12-month lessee renewal options. On January 1, 2020, it was not reasonably assured (under Topic 840) that LE would exercise any of the renewal options; therefore, the 'lease term' was 12 months.

As of the effective date (January 1, 2022 for LE), LE has exercised two of the renewal options – i.e. as of the effective date, the current non-cancellable period of the lease extends to December 31, 2022. At no point before exercise was it ever 'reasonably certain' that LE would exercise one or more of those options, and it is not reasonably certain at the effective date that LE will exercise its one remaining option to extend the lease to December 31, 2023.[9]

In this scenario, LE's lease would qualify as a short-term lease as of the January 1, 2022 effective date. This is because, even though with hindsight LE knows that the term of the lease will be at least three years from January 1, 2020, the original lease term was only 12 months and no single renewal option LE exercised up to the effective date extended the lease term by more than 12 months from the end of the previously determined lease term.

If, in contrast, LE's lease had an original lease term of 12 months at January 1, 2020, but LE had exercised a renewal of greater than 12 months at any point before the effective date, or had exercised more than one of the available 12-month renewal options during the same then-current 12-month lease term, we believe hindsight would preclude characterizing the lease as a short-term lease at January 1, 2022.

Other considerations

Entities that elect the short-term lease exemption should ensure they are aware of, and are prepared to meet, the disclosure requirements that apply for short-term leases subject to the exemption. Those entities should also have adequate processes and controls in place to assess 'lease term' so that only leases eligible for the exemption are not recognized on the balance sheet. If an entity has decided to elect the short-term lease exemption, it should likely disclose that decision in its SAB Topic 11.M (or SAB 74) transition disclosures before the effective date.

9. See section 5.2 of KPMG Handbook, Leases for discussion of 'reasonably certain'.

Effective date

Topic 842 was effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2018.

Not-for-profit entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2019 if they:

— 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
— have not yet issued GAAP-compliant financial statements reflecting the adoption of Topic 842 before June 3, 2020.

All other entities apply Topic 842 for annual periods in fiscal years beginning after December 15, 2021, and interim periods in fiscal years beginning one year later.

For further information

For more information about the short-term lease exemption, lease term and the use-of-hindsight transition practical expedient, see sections 6.3.1, 5.3, and 13.2, respectively, of KPMG Handbook, Leases.

See KPMG Executive View on transition disclosures to be made under SAB Topic 11.M.

This document is part of a series to highlight implementation issues that are discussed in KPMG Handbook, Leases.