



Executive Summary

Topic 842, Leases – Lessors

August 2021[^]



While Topic 842 does not fundamentally change lessors' accounting, there are important differences from Topic 840 and new incremental disclosure requirements

In a snapshot

The FASB's new leases standard (Topic 842) has now been adopted by all *public* companies reporting under US GAAP, and most of those companies have issued their first set of annual financial statements under Topic 842. Meanwhile, the FASB has recently given private companies additional time (to 2022) to implement Topic 842.

- Lessees will recognize lease assets and lease liabilities on-balance sheet.
- Lessor accounting is not fundamentally changed, but important differences from legacy US GAAP (Topic 840) exist.
- Lessees and lessors will disclose key information about their leasing transactions.

Alignment with new revenue recognition standard. Key aspects of the lessor accounting guidance have been aligned with the guidance in the new revenue recognition standard (Topic 606).

How could it impact your business?

Effect on your customers. Your customers will now be required to recognize all leases, including operating leases, with terms greater than 12 months on their balance sheets. This may lead them to request shorter lease periods or different terms and conditions.

Accounting processes and/or internal controls. While lessor accounting will be substantially unchanged, some systems, processes and control changes will likely be necessary to comply with the changes to lessor accounting that will result from Topic 842 and the increased lessor disclosure requirements.

[^] August 2021 updates address the amendments to Topic 842 in ASU 2021-05, [Lessors—Certain leases with variable lease payments](#). The updated section is indicated with #. Lessors that have adopted Topic 842 may apply ASU 2021-05 either prospectively or retrospectively. Lessors that have *not* adopted Topic 842 will follow the transition requirements for 'other types of entities' outlined on page 2. Early adoption is allowed but not before adopting Topic 842. See KPMG Defining Issues, [Change to Topic 842 ends Lessor Day 1 losses from variable lease payments](#).



Effective dates

	Public business entities ¹	Other types of entities
When is Topic 842 effective?	Annual and interim periods in fiscal years beginning after 12/15/2018	<ul style="list-style-type: none"> — Annual periods in fiscal years beginning after 12/15/2021 — Interim periods in fiscal years beginning after 12/15/2022
Can entities early adopt?	Yes, all entities can adopt Topic 842 immediately	

Note 1: For public not-for-profit entities (i.e. one that has issued or is 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 adoption 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 deferral 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.



Lessor accounting model substantially unchanged

Topic 842 retains same basic lessor accounting model

A lessor will classify leases as (1) sales-type, (2) direct financing, or (3) operating using criteria similar to Topic 840. Leveraged lease classification, however, will be eliminated prospectively.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	<ul style="list-style-type: none"> —Recognize net investment in the lease —Derecognize the underlying asset 	<ul style="list-style-type: none"> —Selling profit (loss)¹ —Interest income over the lease term 	Cash received from leases classified as operating cash flows ²
Operating leases	Continue to recognize the underlying asset	Lease income generally on a straight-line basis over the lease term	Cash received from leases classified as operating cash flows

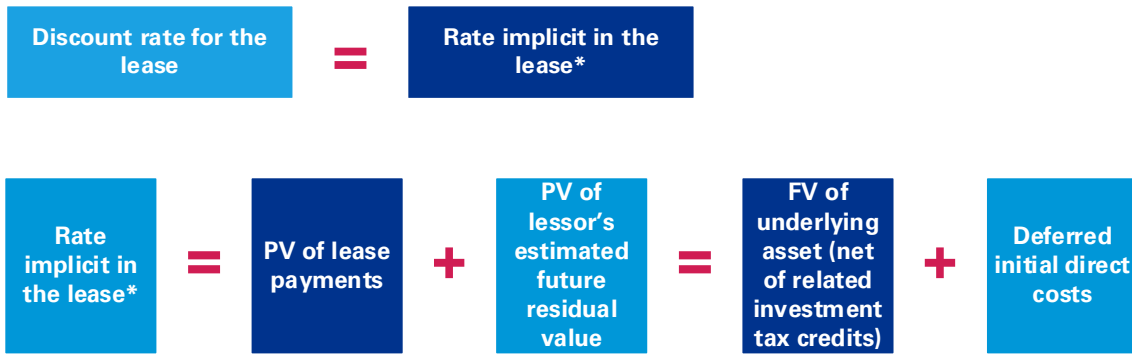
Notes:

1. Selling profit is recognized at lease commencement for sales-type leases and over the lease term for direct financing leases. Selling losses are recognized at lease commencement for both sales-type and direct financing leases.
2. For lessors that are depository or lending institutions in the scope of Topic 942 only, the principal portion of lessee payments received should be classified as cash flows from investing activities.



Other key considerations

Net investment in the lease	=	Lease receivable	+	Unguaranteed residual asset
Lease receivable	=	Present value (PV) of the lease payments	+	PV of guaranteed portion of estimated residual value
Unguaranteed residual asset	=	PV of unguaranteed portion of estimated residual value		
Lease payments	=	Undiscounted fixed (including in-substance fixed) payments	+	Optional payments that are reasonably certain to be paid



* The rate implicit in the lease cannot be less than zero.

Key changes from Topic 840#

Certain items will no longer preclude sales-type lease classification

Collectibility uncertainties

- Unlike Topic 840, a lease with collectibility uncertainties can be classified as a sales-type lease under Topic 842. If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable for a sales-type lease, lease payments received (including variable lease payments) are recognized as a deposit liability (i.e. not recognized as lease income) and the underlying asset is not derecognized generally until collectibility of the remaining amounts becomes probable.
- When collectibility is not probable for a lease that otherwise would be a direct financing lease, it is classified as an operating lease. Lease income recognized for operating leases when collectibility is not probable is limited to cash received from the lessee until collectibility of the remaining lease payments becomes probable.

Unreimbursable costs

- Unlike Topic 840, a commitment by the lessor to guarantee performance of the leased asset in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the asset will not preclude sales-type lease classification.

Significant variable lease payments (before adopting ASU 2021-05)

- Unlike Topic 840, leases with variable payments may be classified as sales-type or direct financing leases even if such classification results in recognizing a loss at lease commencement (a 'Day 1 loss'). A Day 1 loss could result from sales-type or direct financing lease classification because the net investment in the lease, which excludes any variable payments not dependent on an index or rate, will be less than the carrying amount of the underlying asset.*

*** Net investment in the lease - carrying amount of underlying asset = loss amount**

After adopting ASU 2021-05, a lessor will classify a lease for which some or all of the payments are variable payments that do not depend on an index or rate as an operating lease if (1) the lease would have been classified as a sales-type or direct financing lease under the pre-ASU 2021-05

classification criteria and (2) sales-type or direct financing lease classification would result in a Day 1 loss. This will result in lease classification conclusions for these leases that is more closely aligned with those reached under Topic 840.



A narrower definition of initial direct costs

- The new definition of initial direct costs includes only those “incremental costs of a lease that would not have been incurred if the lease had not been obtained,” which is narrower than Topic 840.
- Some costs (e.g. legal fees and allocated internal costs) that an entity defers as initial direct costs under Topic 840 will be expensed when incurred under Topic 842. For some lessors, this may result in recognizing more expenses before the start of a lease and higher margins on lease income earned over the lease term.

Typical initial direct costs	
Include	Exclude
<ul style="list-style-type: none"> — Commissions — Payments made to an existing tenant to incentivize that tenant to terminate the lease 	<ul style="list-style-type: none"> — Legal fees — Costs of evaluating the prospective lessee’s financial condition — Costs of negotiating lease terms and conditions — General overheads



Other important changes



Lease and non-lease components

Contract consideration allocated between the lease and non-lease components

- Topic 842 requires a lessor to separate lease components from non-lease components of a contract and then allocate the consideration in the contract to each separate lease and non-lease component based on the transaction price allocation guidance in Topic 606 (unless the practical expedient is elected).

Practical expedient to combine lease and non-lease components

As a practical expedient, a lessor may elect, by class of underlying asset, to not separate lease and non-lease components that would be within the scope of Topic 606 and, instead, account for them as a single, combined component when the following two criteria are met:

- the timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- the lease component, if accounted for separately, would be classified as an operating lease.

If the non-lease component(s) is (are) the predominant component(s) of the combined component, the lessor should account for the combined component under Topic 606 (as a single performance

obligation) instead of Topic 842. All other combined components are accounted for under Topic 842 as a single lease component classified as an operating lease.



Sale-leaseback accounting may be significantly different for buyer-lessors

- In a significant change from Topic 840, buyer-lessors are required to evaluate whether they have purchased the underlying asset based on the transfer of control (i.e. sale) guidance in Topic 606.
- If the transaction does not qualify as a sale/purchase of the underlying asset, the buyer-lessor accounts for the transaction as a financing arrangement and recognizes a financial asset (i.e. a receivable).
- If the transaction does qualify as a sale/purchase of the underlying asset, the buyer-lessor accounts for the purchase of the underlying asset in the same manner as any other purchase of a nonfinancial asset, subject to a requirement to adjust the purchase price of the underlying asset for off-market terms (e.g. if the buyer-lessor pays more or less than fair value for the asset).



Executory costs

The concept of executory costs that exists under Topic 840 no longer exists in Topic 842.

- Maintenance is a non-lease service component under Topic 842.
- Costs of property taxes and insurance will be accounted for based on who (the lessee or the lessor) pays the relevant third-party (e.g. the taxing authority or the insurance provider) for the cost.
 - If the lessor pays the third-party, and therefore recovers the cost through payments it receives from the lessee (whether fixed or variable), the lessor will recognize the cost and the lessee’s payments gross in the income statement.
 - If the lessee pays the third-party directly – e.g. remits payment of the tax directly to the taxing authority or pays the insurance premium to the insurer – the lessor will recognize the cost and the lessee’s payment thereof net in the income statement. This is regardless of whether the lessor was primarily obligated to or primarily benefitted from the cost and regardless of whether the lessor knows, can readily determine or can reliably estimate the amount of the cost paid by the lessee.
- Topic 842 provides a practical expedient for lessors to, as an accounting policy election, account for all sales and other similar taxes and lessee payments thereof on a net basis.



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 lessor’s disclosures will include:

Qualitative	Quantitative
<ul style="list-style-type: none"> — Significant accounting judgments and estimates — Information about the nature of leases, such as the nature of variable payment arrangements, and termination, renewal, and purchase options — Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk 	<ul style="list-style-type: none"> — Maturity analysis of lease receivables for sales-type and direct financing leases and of lease payments for operating leases — Selling profit (or loss) recognized at lease commencement and interest income for sales-type and direct financing leases — Operating lease income — Variable lease income

The descriptive and summary statements in this newsletter are not intended to be a substitute for the requirements of the standard or any other potential or applicable requirements of the accounting literature or SEC regulations. Companies applying US GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

[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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