Hot Topic: ASC 842

Lessee accounting for variable payments

Allocating variable lease payments to lease and non-lease components may be an unexpected challenge for many lessees.

Key impacts

Topic 842 requires lessees to allocate all variable payments arising from a lease contract, regardless of their nature or to what they relate, to the separate lease and non-lease components of the contract – unless the lessee non-separation practical expedient is elected.[1] The portion of such payments allocated to the lease is disclosed as variable lease cost.

It may not be intuitive to lessees that variable payments for things such as property taxes and insurance will not be allocated solely to the lease, or that variable payments for common area maintenance (CAM) costs will not be allocated solely to the CAM.

Because variable payments must be allocated to the lease and non-lease components of the contract, lessees may require new systems or processes (and related controls) to allocate a single variable payment to multiple components and capture the lease portion of those payments for disclosure.

Variable payment reminders

Effect on measurement of the lease liability and ROU asset

Under Topic 842, variable payments (other than those that depend on an index or a rate, such as CPI or fair market rent[2]) are not part of the 'consideration in the contract' for a lessee. Therefore, they are not included in measuring the lease liability or the right-of-use (ROU) asset at lease commencement or at any point in the lease term thereafter.

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1 See section 4.4.1 of KPMG's Handbook, [Leases](#).
2 See KPMG's Hot Topic [Fair market rent adjustments](#).

Identifying components

Variable payments are allocated to the separate lease and non-lease components of the contract. Not every element of a contract that contains a lease is necessarily a 'component'. While it may seem reasonable to assume that any activity or payment that is not a lease component or an explicit 'lease payment' must be a non-lease component, this is not how Topic 842 works. Instead, some elements of a contract are not components because they do not transfer a good or service to the lessee. Examples include a lessee's reimbursement or payment (to a third party) of the lessor's property taxes and insurance.

Recognition

The portion of a variable payment allocated to the lease component is a variable lease payment. Variable lease payments are recognized when incurred. For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual and interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent target achievement is probable. Variable lease costs recognized are reversed if it becomes probable that the specified target will not be met. This means that the cumulative amount of variable lease cost recognized at any point in time during the lease term will be the amount of variable lease payments that are either paid (and nonrefundable) or probable of being paid.

Lessees must allocate variable payments

Unless the non-separation practical expedient is elected, a lessee must always allocate variable payments to the separate lease and non-lease components of the contract. This includes (1) situations in which the variable payment, such as a variable payment of the lessor's property taxes or building insurance, appears to specifically relate to only one of the components, and (2) where the payments under the contract are entirely variable.

Lessees allocate variable payments to the separate lease and non-lease components on the same relative stand-alone price basis used to allocate the fixed consideration in the contract to those components.

Determining stand-alone prices

Lessees determine stand-alone prices as follows.

— When there *is* an observable stand-alone price for each component: use those stand-alone prices to allocate the consideration in the contract to each component.

— When there *is not* an observable stand-alone price for some or all components: estimate the stand-alone price, maximizing the use of observable information.

An observable stand-alone price is the price charged by the lessor or similar suppliers for a similar lease or non-lease component – i.e. a lease of a substantially similar asset or non-lease component under similar terms and conditions (e.g. with respect to duration and payment terms) – on a stand-alone basis.

We believe it was the FASB's intent that lessees should not have to exhaustively search for observable stand-alone prices, particularly when such a requirement might put significant pressure on lessors to provide proprietary information to lessees.

Estimation techniques used should be reasonable, applied consistently to similar circumstances, and not developed with a bias to reducing amounts allocated to lease components.

Using the residual approach to estimate stand-alone prices

In some circumstances, using a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate. However, it will generally not be appropriate for a lessee to default to the residual approach when another approach would give a more representative result.

We believe four criteria need to be met for a lessee to use the residual approach to estimate the stand-alone price of a component of a contract. These criteria are broadly consistent with those for lessors because the allocation guidance for lessees was intended to be similar to, and was largely drawn from, the Topic 606 (revenue from contracts with customers) transaction price allocation guidance lessors are required to apply.

In the following discussion, Criteria 1 and 2 are included in Topic 842, while Criteria 3 and 4 are drawn from the FASB's statement that the lessee allocation guidance is intended to be similar to that for lessors (without directing lessees to use the revenue recognition guidance).

Criterion 1: Highly variable or uncertain stand-alone price

Using the residual approach to estimate the stand-alone price of a component is appropriate only if the stand-alone price of the component to which the approach would be applied is highly variable or uncertain.

Stand-alone price is …	… if …
Highly variable	The price at which the lessee could purchase the same or a substantially similar good or service in the same timeframe is widely varied.
Uncertain	The same or a substantially similar good or service is not, and has not previously been, sold on a stand-alone basis such that its stand-alone price has not been established.

Criterion 2: Other observable data is considered first

Topic 842 requires that the method used to estimate a stand-alone price maximize the use of observable inputs (or information). Therefore, before using a residual estimation approach, the lessee must consider whether another estimation approach that maximizes the use of observable information/inputs, such as observable cost and/or margin information, is more appropriate.

Criterion 3: Residual approach does not produce zero or de minimis stand-alone price

We believe a residual estimation approach is not appropriate if it results in zero or very little consideration being allocated to a component, or to a bundle of components. It is inconsistent with the view that the component transfers a good or service (i.e. provides benefit to the lessee) to conclude that it has no stand-alone value.

Criterion 4: Observable stand-alone prices for other components

To apply the residual approach, the lessee needs to have observable stand-alone prices for the components of the contract for which the residual approach will not be used to estimate their stand-alone prices.

Residual bundles

If two or more goods or services in a lease have highly variable or uncertain stand-alone prices, a lessee may need to use a combination of methods to estimate the stand-alone prices of the lease and non-lease components in the contract. For example, the lessee may use:

- the residual approach to estimate the aggregate stand-alone prices for all of the components with highly variable or uncertain stand-alone prices; and then
- another technique to estimate the stand-alone prices of the components in the residual bundle.

Lessee Example

Allocating variable payments for property taxes and insurance in a net lease

Lessee LE and Lessor LR enter into a five-year lease of retail space that includes CAM services throughout the lease term. LE will pay LR a fixed payment of $90,200 per year (in arrears) for Year 1, increasing by $5,000 per year thereafter. The lease is classified as an operating lease.

- LE reimburses LR for its pro rata portion of LR's actual property taxes, insurance costs and CAM costs during the lease term.
- LE's initial direct costs are $5,000 (broker commissions), in this example allocated entirely to the lease.[3]
- LR provides a moving allowance (i.e. a lease incentive) to LE of $7,500, which it pays at lease commencement.

Consideration in the contract

The consideration in the contract for LE is $493,500, equal to the sum of the payments of $90,200 for year 1 and increasing $5,000 each year thereafter ($501,000 in total), less the lease incentive received of $7,500.

The amounts LE expects to pay to LR for property taxes, insurance and CAM are variable payments that are excluded from LE's measurement of the consideration in the contract. This is because they do not depend on an index or rate (and are not in-substance fixed).

Allocation of the consideration in the contract to components

If LE separates the lease and the CAM components of this contract, it allocates the consideration in the contract in proportion to the stand-alone prices of the two components.

The stand-alone prices are assumed to be $570,000 (lease) and $30,000 (CAM).

- The estimated stand-alone price of CAM equals the estimated actual CAM cost reimbursements plus an assumed market-based profit margin for those CAM services.
- The estimated stand-alone price of the lease is an estimate of what a lessor would charge for the lease without providing CAM – while still recovering its property tax and insurance costs through the fixed lease payments.

In contrast, if LE elects not to separate lease and CAM components, there is no allocation of the consideration in the contract or the variable payments between the lease and the CAM.

Lessee LE elects to separate lease and non-lease components

LE allocates the consideration in the contract of $493,500 in proportion to stand-alone prices.

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[3] See Example 5.5.30 in KPMG's Handbook, Leases.

Component	Stand-alone price	Allocation	Calculation
Lease	$570,000	$468,825	(570,000 / 600,000) × 493,500
CAM	30,000	24,675	(30,000 / 600,000) × 493,500
	$600,000	**$493,500**	

The allocation results in 95% of the consideration in the contract being allocated to the lease component and 5% being allocated to the CAM non-lease component.

Lessee LE elects not to separate lease and non-lease components

Because LE elects not to separate lease and CAM components, the entire consideration in the contract of $493,500 is allocated to the single lease component of the contract.

Accounting for lease and non-lease components

Lessee LE elects to separate lease and non-lease components

The rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%.

LE determines its lease liability by calculating the present value of the allocated unpaid lease payments of $475,950 (equal to $468,825 of allocated unpaid lease payments + an allocation of the lease incentive of $7,125, which is $7,500 received × 95%), discounted at 5%, to arrive at the lease liability initial measurement of $410,118.

— LE's initial measurement of its ROU asset is $407,993, calculated as follows:

  Lease liability ($410,118) + Initial direct costs ($5,000) + Prepaid lease payments (none) – Lease incentives received ($7,125 [$7,500 × 95%])

— LE's total lease cost is $473,825 (allocated lease payments, net of allocated lease incentives, of $468,825 + initial direct costs of $5,000) and is recognized straight-line over the lease term – i.e. $94,765 each year.

— Amounts allocated to CAM of $24,675 (which is net of allocated lease incentives of $375) are recognized over the service period.

— Payments for property taxes, building insurance and CAM are variable payments. These variable payments are allocated in the same manner as fixed payments (i.e. 95% to the lease component and 5% to CAM) and recognized as incurred. The following table illustrates the allocation of the Year 1 variable payments. LE will replicate this exercise in Years 2-5..

Year 1 variable payments	Variable lease expense	CAM expense	Total
CAM	$ 5,700	$300	$ 6,000
Property taxes	2,850	150	3,000
Insurance	1,900	100	2,000
	$10,450	**$550**	**$11,000**

Lessee LE elects not to separate lease and non-lease components

The rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%. LE determines its lease liability by calculating the present value of the unpaid lease payments of $501,000 ($493,500 of unpaid lease payments + lease incentive of $7,500), discounted at 5%, to arrive at the lease liability initial measurement of $431,703.

— LE's initial measurement of its ROU asset is $429,203:

Lease liability ($431,703) + initial direct costs ($5,000) + prepaid lease payments (none) - lease incentive received ($7,500)

— LE's total lease cost is $498,500 (lease payments, net of lease incentives, of $493,500 + initial direct costs of $5,000) and is recognized on a straight-line basis over the lease term – i.e. $99,700 each year.

— Payments LE makes for property taxes, building insurance and CAM throughout the lease term are accounted for entirely as variable lease payments because there is only a single lease component of the contract. Note the difference in the table that follows as compared to the one where LE separates the lease and CAM components of the contract.

Year 1 variable payments	Variable lease expense	CAM expense	Total
CAM	$ 6,000	$ --	$ 6,000
Property taxes	3,000	--	3,000
Insurance	2,000	--	2,000
	$11,000	**$ –**	**$11,000**

Effective date

Topic 842 is effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2018. It is effective for private companies for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. Early adoption is permitted for all entities.

For further information

For more information about the accounting for variable payments in Topic 842, see chapter 4 and section 6.4 of KPMG's Handbook, Leases.

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

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