



HOT TOPIC

ASC 842

Year-end lease reporting reminders

December 2023 (November 2024)



Key presentation and disclosure reminders about preparing annual financial statements under Topic 842.

Key impacts

Topic 842 (leases) includes significant presentation and disclosure requirements. This Hot Topic contains presentation and disclosure reminders from, among other sources, SEC comment letters to registrants about their Topic 842 accounting and reporting and our own ongoing practice discussions.

The SEC staff has commented on various aspects of companies' accounting and reporting under Topic 842, for both lessees and lessors. Those comments most frequently relate to incomplete or missing disclosures required by Sections 842-20-50 (lessees) and 842-30-50 (lessors). This Hot Topic is not a comprehensive summary of all the presentation and disclosure requirements in Topic 842; rather, it highlights items that we believe companies should pay particular attention to. See sections 6.9 and 7.7, and chapter 12, of KPMG Handbook, [Leases](#), for a complete discussion of the Topic 842 lessee presentation, lessor presentation and disclosure requirements, respectively.

Operating and finance lease balances must be presented separately from each other

While not required to be presented separately on a lessee's balance sheet, Topic 842 *prohibits* lessees from presenting (1) finance lease ROU assets and operating lease ROU assets and (2) finance lease liabilities and operating lease liabilities in the same balance sheet line item. [\[842-20-45-1, 45-3; ASU 2016-02.BC264\]](#)

If these items are not presented separately in the balance sheet (e.g. finance lease ROU assets are presented together with PP&E, or operating lease liabilities are presented together with Other liabilities), they must be separately disclosed in the notes. The disclosure must specify in which balance sheet line items they are presented. [\[842-20-45-1 – 45-2\]](#)

Lessee discount rate disclosures

Lessees are required to disclose how they determine the discount rate for their leases, including related assumptions and judgments. In the vast majority of cases, the discount rate for a lease will be the lessee's incremental borrowing rate (IBR). [\[842-20-50-3\(c\)\(3\)\]](#)

Basis for use of IBR vs the implicit rate

Under Topic 842, a lessee uses the rate implicit in the lease as the discount rate for a lease *if it is 'readily determinable'*. However, that rate is typically *not* readily determinable, as explained in Question 5.6.20 in KPMG Handbook, [Leases](#). [\[842-20 Glossary\]](#)

In some recent filings, we have observed lessees state that they use their IBR as the discount rate for their leases because “the Company’s leases do not provide [include] an implicit rate [stated rate of interest]”. This is an incorrect basis on which to use the lessee’s IBR instead of the rate implicit in the lease. The rate implicit in the lease is a *calculated* rate. It is not, therefore, a rate that is stated/provided in the lease contract (or provided separately by the lessor) *unless* that stated/provided rate is also (i.e. equals) the calculated rate defined in Topic 842. [\[842 Glossary\]](#)

Therefore, lessees should disclose whether the rates implicit in their leases are readily determinable and, if not, that *that* is the basis for using their IBR as the discount rate for their leases.

How IBR is determined

Generic disclosures that, in effect, merely repeat the Topic 842 IBR definition generally do not satisfy this disclosure requirement. Instead, if lease discount rates are material to the lessee’s financial reporting, the lessee should provide information relevant to how the IBRs reflected in the measurement of its leases were determined. This may include information about what inputs the lessee used, and what adjustments it made to those inputs, in estimating those rates.

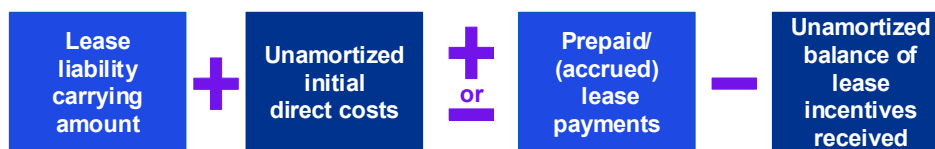
Further, we believe the lessee should disclose the following if applicable:

- that it is using a portfolio approach to determine its IBRs; or
- that it has a significant number of leases for which the IBR reflects the rate of the parent or group, rather than the legal entity (e.g. subsidiary) entering into the lease with the lessor.

ROU asset amortization in operating leases

After lease commencement, unless the ROU asset has been impaired (see section 6.5.1 of KPMG Handbook, [Leases](#)), the carrying amount of an operating lease ROU asset can be determined in one of two ways. These methods produce the same carrying amount of the ROU asset throughout the lease term.

- **Method 1:** The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period – i.e. a lessee measures the ROU asset as follows. [\[842-20-35-3\(b\)\]](#)



- **Method 2:** Amortize the ROU asset, calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) – see paragraph 6.4.190 of KPMG Handbook, [Leases](#) – and the periodic accretion of the lease liability using the effective interest method.



For additional information on the subsequent accounting for lessee operating leases, see section 6.4.2 of KPMG Handbook, [Leases](#).

We have observed that most companies, and most leasing IT systems, subsequently measure the ROU asset using Method 2.

Based on our observations of SEC comment letters, we believe companies should not refer to the periodic change in the carrying amount of the ROU asset in an operating lease as ‘amortization’. This includes when (not exhaustive):

- disclosing the effect of this change in the income statement (i.e. as part of the single operating lease cost); or
- reconciling lease expense to lease payments in the operating section of the statement of cash flows (see next item).

With respect to the latter, we believe an alternative description (not referring to amortization), such as ‘Reduction in the carrying amount of ROU assets’, should be used instead.

We believe the SEC staff has commented in this regard because Topic 842 does not characterize the reduction in the ROU asset that occurs over the lease term as ‘amortization’. Instead, it only refers to recognition of a ‘single lease cost’ by lessees, of which the periodic reduction in the carrying amount of the ROU asset is an element, and describes subsequent measurement of the ROU asset only in the manner of Method 1 above. [\[842-20-35-3\(b\), ASU 2016-02.BC64\]](#)

Operating lease cash flow presentation

Topic 842 does not address how to reconcile the lease expense to the lease payments in the reconciliation of net income to net cash flows from operating activities. Consistent with legacy US GAAP (Topic 840), a lessee generally recognizes straight-line operating lease expense under Topic 842. However, that straight-line expense now comprises two components:

- amortization of the ROU asset; and
- accretion of the discounted lease liability.

The ROU asset amortization is noncash and is therefore an adjustment to reconcile net income to net cash flows from operating activities.

The lease liability is reduced by the cash payments for leases, offset by accretion. Consistent with other working capital adjustments, this change in the lease liability is also presented as an adjustment to reconcile net income to net cash flows from operating activities.

Adjustments to net income and changes in net assets should be clearly identified in the reconciliation of net income to net cash flows from operating activities. [\[230-10-45-32\]](#)

We believe there are two acceptable approaches to presenting the ROU asset amortization (a noncash expense) and the change in the lease liability (a change in net assets).

- **Approach 1:** Present the ROU asset amortization and the change in the lease liability in different line items.
- **Approach 2:** Present the ROU asset amortization and the change in the lease liability in the same line item.

We believe Approach 2 is acceptable despite the two adjustments being of a different nature (i.e. noncash expense and a change in net assets). This is because Topic 842 does not characterize the single operating lease cost as the combination of two separately derived components (i.e. ROU asset amortization and lease liability accretion). In addition, we note that at the December 2, 2020 FASB meeting, the FASB Vice Chair stated that he did not believe Topic 842 changed operating lease cash flow presentation from Topic 840, which implicitly supports the single, combined amount approach.

The presentation approach selected should be disclosed and applied consistently. We believe either of these approaches can be achieved by including the separate amounts (Approach 1) or combined amount (Approach 2) in existing line items such as 'Change in liabilities', or by creating new line items such as 'Reduction in the carrying amount of ROU assets' or 'Change in operating lease liabilities'.

However, consistent with the reminder about ROU asset amortization in operating leases, we believe that adjustments attributable to ROU asset amortization should not be characterized as 'amortization' or included with other amounts labelled as amortization.

This item is reproduced from Question 14.2.85 in KPMG Handbook, [Statement of cash flows](#).

Practical expedient to not separate lease and non-lease components

A lessee that elects the practical expedient to not separate lease and non-lease components must disclose both: [\[842-20-50-9\]](#)

- its election of the practical expedient; and
- the class(es) of underlying asset(s) for which it has elected the practical expedient.

Companies should be mindful not to neglect the second requirement.

Variable lease and short-term lease cost disclosures

Ensure variable lease cost and short-term lease cost are disclosed separately

Topic 842 requires separate disclosure of a lessee's variable and short-term lease costs. It is not appropriate to disclose those costs as only a single amount. [\[842-20-50-4\(c\) – 50-4\(d\)\]](#)

Variable short-term lease cost

Some short-term leases include variable payments. A question arises about whether such costs should be disclosed together with other short-term lease costs or with other variable lease costs. We believe the short-term lease cost disclosure is intended to be comprehensive for those leases; therefore, we believe variable short-term lease costs should be disclosed together with other short-term lease costs, rather than in the variable lease cost line. However, because Topic 842 is not clear in this regard, we believe disclosing variable short-term lease cost with other variable lease cost would also be acceptable. If a lessee has material variable short-term lease cost, it should disclose where those amounts are included in its quantitative lease cost disclosures.

Completeness of variable lease costs

Lessees need to ensure that the variable lease costs disclosure includes all amounts that meet the definition of such costs. As a reminder, variable lease costs are not only those amounts that relate to

performance or use of the underlying asset (e.g. percentage rent or per-usage fees), but also include any other variable lease payments not included in the measurement of the lease liability. Examples include, but are not limited to:

- incremental rent, above the amount included in the lease liability, paid during the year due to a change in CPI;
- the portion of property or ad valorem taxes or insurance payments attributable to the lease component (if there are non-lease components of the contract), or the entirety of such payments if there are no non-lease components or the lessee has elected not to separate lease and non-lease components (see section 4.2.1 of KPMG Handbook, [Leases](#)); and
- the portion of variable maintenance (e.g. common area maintenance [CAM]) or other service payments attributable to the lease component, or the entirety of such payments if the lessee has elected not to separate lease and non-lease components (see section 4.4.3 of KPMG Handbook, [Leases](#)).

Section 5.4.1 in KPMG Handbook, [Leases](#), provides additional information on what comprises variable lease payments.

Nature of variable lease payments disclosure

Lessees are required to disclose information about the nature of their leases, including the basis and terms and conditions on which variable lease payments are determined. [\[842-20-50-3\(a\)\(2\)\]](#)

This information allows users to better understand a company's leasing strategy and how future lease payment obligations may differ from the amounts recognized (i.e. lease liabilities) on the balance sheet. To the extent variable lease cost is material, we believe a company should provide more robust disclosures about its variable lease payment arrangements, especially if variable lease cost is a significant portion of the company's total lease cost. These disclosures might include, but not be limited to, information about:

- why their arrangements contain significant variable payments;
- the basis on which the variable lease payments become owed; and
- expectations of, and the reasons for, significant variability in amounts owed from period to period.

Lease-related non-GAAP adjustments

The SEC has issued several comment letters about lease-related adjustments to non-GAAP measures (e.g. EBITDA or adjusted EBITDA). Items questioned by the SEC staff have included:

- removing the noncash portion of lease expense from the applicable non-GAAP measure;
- using an EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) measure when rental expense appears to be a normal, recurring operating expense; and
- making adjustments to align with legacy lease accounting guidance or IFRS® Accounting Standards.

The SEC staff have referred the recipients in many of these cases to Questions 100.01 on normal, recurring cash operating expenses and 100.04 on tailored accounting principles of the [SEC's Compliance and Disclosure Interpretations regarding Non-GAAP Financial Measures](#) and Rule 100(b) of Regulation G. Companies should consider these items when evaluating whether a lease-related non-GAAP adjustment is proper. KPMG Issues In-Depth, [Non-GAAP Financial Measures](#), provides detailed guidance on SEC rules for non-GAAP measures.

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

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