

FINANCIAL ACCOUNTING SERIES

ACCOUNTING STANDARDS UPDATE

No. 2021-05
July 2021

Leases (Topic 842)

Lessors—Certain Leases with Variable Lease Payments

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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Please ask for our Product Code No. ASU 2021-05.

FINANCIAL ACCOUNTING SERIES (ISSN 0885-9051) is published monthly with the exception of January, March, July, and October by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Periodicals postage paid at Norwalk, CT and at additional mailing offices. The full subscription rate is \$328 per year. POSTMASTER: Send address changes to Financial Accounting Series, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. | **No. 507**

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

On February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

As part of the Board's post-implementation review (PIR) of Topic 842, the Board and staff continue to assist stakeholders by responding to inquiries received and proactively seeking feedback on potential implementation issues that have arisen as public business entities began implementing Topic 842. Since the issuance of Update 2016-02, the Board has issued five Updates to assist stakeholders with implementation issues and two Updates deferring the effective date for private companies and certain not-for-profit organizations. Additionally, the FASB staff has responded to approximately 300 technical inquiries during that time. Finally, the Board has provided a dedicated section on its website for PIR.

Also as part of the Board's PIR of Topic 842, the Board and staff continue to perform outreach with various stakeholder organizations to address any additional issues that may have arisen since the adoption of Topic 842 by public business entities. The amendments in this Update address an issue related to a lessor's accounting for certain leases with variable lease payments.

Who Is Affected by the Amendments in This Update?

The amendments in this Update affect lessors with lease contracts that (1) have variable lease payments that do not depend on a reference index or a rate and (2) would have resulted in the recognition of a selling loss at lease commencement if classified as sales-type or direct financing.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease or a direct financing lease at lease commencement on the basis of specified classification criteria (see paragraphs 842-10-25-2 through 25-3). Under Topic 842, a lessor is not permitted to estimate most variable payments and must exclude variable payments that are not estimated and do not depend on a

reference index or a rate from the lease receivable. Subsequently, those excluded variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the net investment in the lease for a sales-type lease or a direct financing lease with variable payments of a certain magnitude that do not depend on a reference index or a rate may be less than the carrying amount of the underlying asset derecognized at lease commencement. As a result, the lessor recognizes a selling loss at lease commencement (hereinafter referred to as a day-one loss) even if the lessor expects the arrangement to be profitable overall.

Certain preparers and practitioners have continued to highlight that recognizing a day-one loss for a sales-type lease with variable payments that do not depend on a reference index or a rate results in reporting outcomes that do not faithfully represent the underlying economics either at lease commencement or over the lease term. Those stakeholders emphasized that users of financial statements are not provided with financial information that is relevant or decision useful in those cases. Rather, the reporting of a loss is counter to the economics of those arrangements, and, thus, the accounting previously required fails to represent the underlying economics neutrally and faithfully. Lease arrangements with variable payment structures based on the performance or use of underlying assets are becoming more prevalent, particularly in the energy industry, and stakeholders from that industry requested that the Board amend the leases guidance to address this issue. This issue also may exist for a direct financing lease with variable payments that do not depend on a reference index or a rate.

Those stakeholders further highlighted that lessors did not recognize a day-one loss under Topic 840, Leases, because of the longstanding practice to account for certain leases with variable payments as operating leases based on an interpretation of a classification criterion in Topic 840. That classification criterion was not retained in Topic 842. Additionally, the resulting day-one loss issue was not identified or discussed by the Board in deliberations leading to the issuance of Update 2016-02.

The amendments in this Update address stakeholders' concerns by amending the lease classification requirements for lessors to align them with practice under Topic 840. Lessors should classify and account for a lease with variable lease payments that do not depend on a reference index or a rate as an operating lease if both of the following criteria are met:

1. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria in paragraphs 842-10-25-2 through 25-3.
2. The lessor would have otherwise recognized a day-one loss.

When a lease is classified as operating, the lessor does not recognize a net investment in the lease, does not derecognize the underlying asset, and, therefore, does not recognize a selling profit or loss. The leased asset continues to be subject to the measurement and impairment requirements under other applicable GAAP

before and after the lease transaction (for example, Topic 360, Property, Plant, and Equipment).

When Will the Amendments Be Effective and What Are the Transition Requirements?

The amendments in this Update amend Topic 842, which has different effective dates for public business entities and most entities other than public business entities. The amendments are effective for fiscal years beginning after December 15, 2021, for all entities, and interim periods within those fiscal years for public business entities and interim periods within fiscal years beginning after December 15, 2022, for all other entities.

Entities that have not adopted Topic 842 on or before the issuance date of this Update should follow the transition requirements of Topic 842 in paragraph 842-10-65-1 for the amendments in this Update. This transition is either (1) retrospective to each prior period presented in the financial statements with the cumulative effect of transition recognized at the beginning of the earliest period presented or (2) retrospective to the beginning of the period of adoption with a cumulative effect of transition recognized at the beginning of the period of adoption.

Entities that have adopted Topic 842 before the issuance date of this Update have the option to apply the amendments in this Update either (1) retrospectively to leases that commenced or were modified on or after the adoption of Update 2016-02 or (2) prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments.

Earlier application is permitted.

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–20. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Amend the following Master Glossary terms, with a link to transition paragraph 842-10-65-5, as follows:

Direct Financing Lease

From the perspective of a **lessor**, a **lease** that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b) and is not an operating lease in accordance with paragraph 842-10-25-3A.

Sales-Type Lease

From the perspective of a **lessor**, a **lease** that meets one or more of the criteria in paragraph 842-10-25-2 and is not an operating lease in accordance with paragraph 842-10-25-3A.

Amendments to Subtopic 842-10

3. Amend paragraph 842-10-15-42A and add paragraph 842-10-25-3A, with a link to transition paragraph 842-10-65-5, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessor

842-10-15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A ~~25-3~~.

Recognition

> Lease Classification

842-10-25-2 A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the **lease payments** and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

842-10-25-3 When none of the criteria in paragraph 842-10-25-2 are met:

- a. A lessee shall classify the lease as an **operating lease**.
- b. A lessor shall classify the lease as either a **direct financing lease** or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
2. It is **probable** that the lessor will collect the lease payments plus any amount necessary to satisfy a **residual value guarantee**.

842-10-25-3A Notwithstanding the requirements in paragraphs 842-10-25-2 through 25-3, a lessor shall classify a lease with **variable lease payments** that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type lease or a direct financing lease would result in the recognition of a **selling loss**.

4. Add paragraph 842-10-65-5 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2021-05, Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments

842-10-65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph when it first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Earlier application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.
- d. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph by using one of the following two methods:

1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraph 842-10-25-8.
2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10-25-8.
- e. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the following transition disclosures:
 1. The applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2) and paragraph 250-10-50-3
 2. The transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the following transition disclosures:
 1. The nature of and reason for the change in accounting principle
 2. The transition method
 3. A qualitative description of the financial statement line items affected by the change.

Amendments to Status Sections

5. Amend paragraph 255-10-00-1, by adding the following items to the table, as follows:

255-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

6. Amend paragraph 310-10-00-1, by adding the following items to the table, as follows:

310-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

7. Amend paragraph 450-30-00-1, by adding the following items to the table, as follows:

450-30-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

8. Amend paragraph 805-10-00-1, by adding the following items to the table, as follows:

805-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

9. Amend paragraph 805-20-00-1, by adding the following items to the table, as follows:

805-20-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

10. Amend paragraph 810-10-00-1, by adding the following items to the table, as follows:

810-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

11. Amend paragraph 840-10-00-1, by adding the following items to the table, as follows:

840-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

12. Amend paragraph 840-20-00-1, by adding the following items to the table, as follows:

840-20-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

13. Amend paragraph 840-30-00-1, by adding the following items to the table, as follows:

840-30-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

14. Amend paragraph 840-40-00-1, by adding the following items to the table, as follows:

840-40-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

15. Amend paragraph 842-10-00-1, by adding the following items to the table, as follows:

842-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021
842-10-15-42A	Amended	2021-05	07/19/2021
842-10-25-3A	Added	2021-05	07/19/2021
842-10-65-5	Added	2021-05	07/19/2021

16. Amend paragraph 842-20-00-1, by adding the following items to the table, as follows:

842-20-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

17. Amend paragraph 842-30-00-1, by adding the following items to the table, as follows:

842-30-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

18. Amend paragraph 842-40-00-1, by adding the following items to the table, as follows:

842-40-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

19. Amend paragraph 860-10-00-1, by adding the following items to the table, as follows:

860-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

20. Amend paragraph 970-340-00-1, by adding the following items to the table, as follows:

970-340-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
Direct Financing Lease	Amended	2021-05	07/19/2021
Sales-Type Lease	Amended	2021-05	07/19/2021

The amendments in this Update were adopted by the affirmative vote of five members of the Financial Accounting Standards Board. Ms. Botosan and Mr. Schroeder dissented.

Ms. Botosan and Mr. Schroeder dissent from the issuance of this Update because of concerns about the amendments and the assessment of whether to reexpose before its issuance.

Concerns about Amendments

Ms. Botosan and Mr. Schroeder acknowledge that excluding certain variable lease payments from the measurement of a lease at inception can give rise to selling losses and profits that do not reflect the economics of the contract reported by lessors whose contracts include a significant portion of variable payments, which is the direct consequence of a prior Board's decision. They would have preferred to reconsider that prior decision holistically for lessees and lessors as part of the ongoing post-implementation review of Topic 842.

Barring a holistic reassessment, Ms. Botosan and Mr. Schroeder would have supported an alternative approach aligned with the one exposed. That proposed approach would have required that lessors classify and account for a sales-type lease with predominantly variable lease payments as an operating lease. They believe that such an approach would have addressed the immediate problem of reporting nonrepresentationally faithful selling losses and profits by lessors whose contracts include a significant portion of variable payments. Furthermore, that approach was supported by most respondents to the proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements*.

During redeliberations, however, a Board majority directed the staff to evaluate an alternative approach recommended by a small number of respondents to the proposed Update. That alternative approach, which was ultimately supported by the Board majority, requires that a lessor classify and account for a sales-type (or direct financing) lease with a selling loss at inception as an operating lease if there

is any amount (referred to in this dissent as a nonzero amount) of variable lease payments.

The revised approach alters the scope of this Update relative to the proposed amendments by extending the scope to direct financing and sales-type leases with a day-one loss, regardless of the magnitude of variable lease payments. In addition, it excludes sales-type leases with selling profits that do not faithfully represent the economic profit resulting from those contracts because of variable payments. Thus, this approach has little to do with the root cause of the accounting misalignment—excluded variable lease payments—but, instead, focuses on day-one losses regardless of their cause.

Also, Ms. Botosan and Mr. Schroeder, citing the basis for conclusions in the proposed Update, observe that “having a threshold that is too low could promote structuring to achieve operating lease accounting.” They believe that reducing the threshold from predominant to a nonzero amount of variable lease payments will invite precisely the type of structuring about which the Board previously expressed concern. Under the amendments in this Update, an entity will be able to choose whether to account for a lease as a sales-type lease (direct financing lease) or an operating lease by structuring the transaction to achieve the desired outcome. The amendments create a rules-based, nonneutral bright line such that any amount of selling loss combined with a nonzero amount of variable lease payments achieves operating lease accounting, whereas any amount of selling profit achieves sales-type (direct financing) lease accounting.

Concerns about Assessment of Whether to Reexpose

Ms. Botosan and Mr. Schroeder disagree with the majority’s evaluation of the factors that the Board considered in evaluating the need for a revised Exposure Draft. Those factors include (1) Is one or more changes during redeliberations significant? and (2) Has the changed guidance previously been exposed for public comment? Their reasoning is outlined in the following paragraphs.

Is One or More Changes during Redeliberations Significant?

The Board’s internal policies, procedures, and guidance (Supplemental PP&G) indicate that financial reporting results that “differ significantly from that which would have been reported under the Exposure Draft” represents a significant change. Ms. Botosan and Mr. Schroeder believe that altering the proposed scope to focus on the existence of a selling loss and reducing the threshold for variable payments from predominant to any nonzero amount will yield financial reporting results that differ significantly from those that would have been reported under the proposed amendments. Therefore, they believe that the revised scope and revised solution both should have been reexposed for public comment.

Has the Changed Guidance Previously Been Exposed for Public Comment?

The Supplemental PP&G indicates that a significant change has been exposed for public comment when the revised amendments revert to existing GAAP or are “responsive to suggestions made and supported by a significant number of respondents and are not opposed by any significant stakeholder group.” Regarding existing GAAP (which is now Topic 842), Ms. Botosan and Mr. Schroeder note that the revised amendments clearly do not revert to existing GAAP, and they believe that the revised amendments do not revert to prior GAAP under the superseded Topic 840. In support of their belief, they note that in outreach all practitioners agreed that Topic 840 did not directly address lessors’ classification of leases with a certain magnitude of variable payments. Rather, lessors’ classification of those leases as operating was based on a practice interpretation of a lessor-classification criterion. They note that the paragraph 840-10-25-42(b) criterion did not refer to the existence of a selling loss, but to “no important uncertainties” surrounding the amount of nonreimbursable costs yet to be incurred by the lessor.

Those practitioners acknowledged that the interpretation was applied inconsistently in practice. For example, one firm observed that lessors with either a day-one gain or a day-one loss would classify and account for a lease as an operating lease under Topic 840 if the lease included a certain magnitude of variable payments. This is like the solution proposed in the Exposure Draft. Others stated that, in their experience, this lessor-classification criterion was applied only to leases that would result in day-one losses, like the requirements in this Update. Most firms agreed, however, that there had been a lack of rigor in applying that criterion, and all firms agreed that applying Topic 840 in this regard was inconsistent. Thus, Ms. Botosan and Mr. Schroeder believe that the amendments in this Update have not been exposed for public comment because the accounting required by this Update does not represent a reversion to existing GAAP.

The Supplemental PP&G also indicates that a significant change may be viewed as having been exposed for public comment when it responds to suggestions made and supported by a significant number of respondents and is not opposed by any significant stakeholder group. Most respondents supported the proposed approach and did not comment on the amendments in this Update. In fact, only 3 of 27 respondents recommended that the Board consider the amendments in this Update. Furthermore, it is impossible to ascertain whether the amendments would be opposed by any significant stakeholder group because no feedback was gathered from the users of lessor financial statements.

In summary, Ms. Botosan and Mr. Schroeder believe that the changes made during redeliberations are significant and that those changes were not exposed for public comment before finalization. Accordingly, they believe that the decision not to reexpose a revised proposed Update is inconsistent with the two factors considered by the Board.

Members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Susan M. Cospers
Marsha L. Hunt
R. Harold Schroeder

Background Information and Basis for Conclusions

Introduction and Background

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. On February 25, 2016, the Board issued Update 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

BC3. As part of the Board's PIR of Topic 842, the Board and staff continue to assist stakeholders by responding to inquiries received and proactively seeking feedback on potential implementation issues that have arisen as public business entities began implementing Topic 842. Since the issuance of Update 2016-02, the Board has issued five Updates to assist stakeholders with implementation issues and two Updates deferring the effective date for private companies and certain not-for-profit organizations. Additionally, the FASB staff has responded to approximately 300 technical inquiries during that time. Finally, the Board has provided a dedicated section on its website for PIR.

BC4. Also as part of the Board's PIR of Topic 842, the Board and staff continue to perform outreach with various stakeholder organizations to address any additional issues that may have arisen since the adoption of Topic 842 by public business entities. The amendments in this Update address an issue related to a lessor's accounting for certain leases with variable lease payments. While this issue was brought to the Board's attention in an agenda request from an energy industry group, it also exists in other industries, particularly those that involve consumable goods. A discussion of the issue and the basis for conclusions reached by the Board for addressing that issue are provided below.

Benefits and Costs

BC5. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial

reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC6. Overall, the Board concluded that the amendments in this Update (a) improve the decision usefulness of information provided to present and potential investors, creditors, donors, and other users without imposing significant implementation or ongoing costs to preparers of financial statements and (b) align with lessor accounting as applied in practice under Topic 840.

Basis for Conclusions

BC7. Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease or a direct financing lease at lease commencement on the basis of specified classification criteria (see paragraphs 842-10-25-2 through 25-3). Under Topic 842, a lessor is not permitted to estimate most variable payments and must exclude variable payments that are not estimated and do not depend on a reference index or a rate from the lease receivable. Subsequently, those variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the net investment in the lease for a sales-type lease or a direct financing lease with variable payments of a certain magnitude that do not depend on a reference index or a rate may be less than the carrying amount of the underlying asset derecognized at lease commencement. As a result, the lessor is required to recognize a day-one loss at lease commencement even if the lessor expects that the arrangement will be profitable overall.

BC8. Certain preparers and practitioners have continued to emphasize that recognizing a day-one loss for a sales-type lease with variable payments that do not depend on a reference index or a rate results in reporting outcomes that do not faithfully represent the underlying economics either at lease commencement or over the lease term. Those stakeholders emphasized that users of financial statements are not provided with financial information that is relevant or decision useful in those cases. Rather, the reporting of a loss is counter to the economics of those arrangements, and, thus, the accounting previously required fails to represent the underlying economics neutrally and faithfully. Lease arrangements with variable payment structures based on the performance or use of underlying assets are becoming more prevalent, particularly in the energy industry, and stakeholders from that industry requested that the Board amend the leases guidance to address this issue. This issue also may exist for a direct financing lease with variable payments that do not depend on a reference index or a rate.

BC9. Those stakeholders further highlighted that the requirement in Topic 842 to recognize a day-one loss for these types of leases was a change from previous practices under Topic 840. They specifically emphasized that lessors did not recognize a day-one loss under Topic 840 because of the longstanding practice to account for certain leases with variable payments as operating leases on the basis of an interpretation of a classification criterion in Topic 840 (see paragraph 840-10-25-42). That classification criterion was not retained in Topic 842. Additionally, the resulting day-one loss issue was not identified or discussed by the Board in deliberations leading to the issuance of Update 2016-02.

BC10. At its July 29, 2020 meeting, the Board discussed the day-one loss issue and agreed that recognizing a loss at lease commencement for lease contracts that a lessor expects to be profitable overall results in reporting outcomes that do not reflect the economics of the transaction. Therefore, the Board decided to amend the lease classification requirements to require that a lessor classify and account for a sales-type lease with lease payments that are predominantly variable and do not depend on a reference index or a rate as an operating lease. On the basis of preliminary feedback received, the Board expected that the “predominant” threshold for variable payments would resolve the issue for many sales-type leases with a day-one loss and not extend in most circumstances to leases that result in day-one gains.

BC11. The Board considered whether a lessor should be required to estimate all variable lease payments (similar to the requirements in Topic 606, Revenue from Contracts with Customers) to address the day-one loss issue. The Board concluded that while that may be a conceptually better solution, it would be inconsistent with the treatment of variable lease payments by lessees and would introduce additional costs and complexity for the lessor that were previously considered in the Board’s deliberations leading up to the issuance of Update 2016-02. The Board noted that no new information exists indicating that those costs and that complexity will be reduced in the current environment. Additionally, the Board considered that the prior Board had generally not intended to change lessors’ accounting when deliberating Update 2016-02. Therefore, the Board rejected a solution that would have required all lessors to estimate variable payments and, instead, provided a practical solution that would have resulted in financial reporting outcomes that more faithfully represent the economics of a sales-type lease with variable payments and a day-one loss and that is consistent with practice before the adoption of the requirements in Topic 842.

BC12. The Board issued the proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements*, on October 20, 2020, with comments due by December 4, 2020. The Board specifically solicited feedback on the appropriateness and operability of the “predominant” threshold for variable payments for determining when a lessor should classify a lease with variable payments that do not depend on a reference index or a rate as an operating lease. The Board received 27 comment letters that responded to the day-one loss issue in the proposed Update. Overall, respondents supported the amendments in the

proposed Update related to that issue because the proposed amendments would result in more relevant and decision-useful financial information. No users of financial statements provided feedback through the comment letter process.

BC13. Notwithstanding the overwhelming support for addressing the accounting to reduce the occurrence of reporting a day-one accounting loss for arrangements expected to be profitable, a significant number of respondents (approximately 20 percent) suggested an alternative. In response to a question in the proposed Update addressing the proposed “predominant” threshold, respondents provided an alternative that would reduce even further the occurrence of reporting day-one losses on transactions expected to be economically profitable by eliminating that proposed threshold. Specifically, several respondents raised concerns about whether the “predominant” threshold would achieve the Board’s objective because it would result in an arbitrary threshold that would exclude many arrangements that have both fixed and variable payment terms that would recognize a day-one accounting loss on an otherwise profitable arrangement. Those respondents recommended that the Board consider additional refinements to address uneconomic day-one losses recognized from leases with variable payments, regardless of whether the variable payments are predominant. Those stakeholders highlighted that the proposed amendments would not address a lessor’s recognition of uneconomic day-one losses from a lease with both fixed and variable payments for which (a) the fixed payments are less than the carrying value of the asset underlying the lease and (b) the variable payments are expected to result in profit overall on the transaction but are not the predominant portion of the payments for the lease. A respondent provided the following example of a transaction that would result in losses continuing to be recognized on profitable transactions under the proposed “predominant” threshold as troubling:

A lease with a mix of fixed and variable payments where the fixed payments were less than the cost of the assets under lease, and the variable payments are expected to result in profit on the transaction but were not the predominant part of the lease payments. (E.g., an asset costing \$60 is leased for \$55 fixed payments and estimated \$45 variable payments.)

BC14. Additionally, a significant number of comment letter respondents who supported addressing the day-one loss issue opposed a threshold for variable payments that would be more restrictive than predominant, for example, a requirement that “substantially all” payments must be variable. Notably, in addition to the significant support for eliminating the threshold, respondents who supported addressing the issue expressed no significant concern about lowering or removing the threshold. Respondents generally agreed that the proposed amendments would reduce uneconomic reporting outcomes, which is consistent with the Board’s decision not to include a threshold for the level of variable payments in this Update. Subsequent staff outreach with respondents and others confirmed that the concerns expressed were one-directional. That is, respondents opposed a higher threshold because it would result in a greater incidence of day-one losses.

However, significant support, both in comment letters and subsequent outreach, existed for not establishing a specific and arbitrary threshold for the level of variable payments required because it would reduce even further the possibility of reporting losses on arrangements that are expected to be profitable.

BC15. Furthermore, multiple stakeholders highlighted that the amendments in the proposed Update would have a broader effect on lessor accounting classification. Those proposed amendments would have changed lessor accounting for sales-type leases with predominantly variable payments that result in the recognition of a selling profit at lease commencement. A lessor would have been required to classify and account for those leases as operating leases if the payments for the lease were predominantly variable, regardless of whether a selling profit would have been recognized. Therefore, several comment letter respondents recommended refining the proposed amendments. Broadly, those stakeholders recommended solutions that would (a) result in more sales-type leases with the day-one loss issue being classified as operating leases, regardless of whether payments for the lease were predominantly variable, and (b) eliminate the possibility of leases with variable payments and selling profit being classified as operating leases. On the basis of that feedback, the staff completed additional outreach with practitioners and preparer groups who represent a significant population of stakeholders affected by this accounting change and/or have significant experience analyzing and accounting for transactions with the day-one loss issue under both Topic 840 and Topic 842, including those that had commented on the proposed Update.

BC16. The Board considered stakeholders' feedback received through comment letters and additional staff outreach and noted that the amendments in the proposed Update were intended to (a) address the uneconomic outcome from recognizing day-one losses (not day-one gains) from sales-type leases with variable payments and (b) provide guidance that would result in accounting outcomes similar to those reached under Topic 840. On the basis of those considerations, the Board decided on an improved approach whereby a lessor should classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at lease commencement if both of the following criteria are met:

- a. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria in paragraphs 842-10-25-2 through 25-3.
- b. The lessor would have otherwise recognized a day-one loss.

BC17. The Board concluded that the amendments in this Update result in outcomes that are better aligned with the outcomes reached in practice under Topic 840 as compared with the amendments in the proposed Update. Additionally, the Board noted that while it had expected that the "predominant" threshold for variable lease payments in the proposed amendments would have addressed many of the leases with the day-one loss issue, stakeholders indicated

that the amendments in this Update would provide a more effective and more operable, narrow-scope solution. Specifically, the amendments more effectively respond to the feedback received because they (a) address all day-one loss issues in leases with variable payments regardless of the magnitude of variable payments and (b) do not change lessor accounting for leases with variable payments and selling profits and are consistent with practice under Topic 840.

BC18. The Board considered whether the amendments in this Update create structuring opportunities whereby lessors could incorporate immaterial variable payment terms to avoid recognizing a day-one loss for sales-type leases or direct financing leases. However, the existing impairment requirements in Topic 360, Property, Plant, and Equipment, or the measurement requirements in Topic 330, Inventory, should be sufficient to capture most arrangements that have economic "selling losses" at or before lease commencement. Specifically, in applying the impairment requirements in Topic 360, if expected cash flows from the asset underlying a lease are not expected to be sufficient, the carrying value of the asset is likely not recoverable and, therefore, the lessor would recognize an impairment loss before the lease commences. Additionally, the Board noted that payments that do not create genuine variability (such as those that result from clauses that do not have economic substance) are considered in substance fixed payments (rather than variable payments) under Topic 842. Therefore, the Board did not require a specific level of variable lease payments to account for a lease as an operating lease. The Board emphasized that the amendments do not change the impairment guidance and, therefore, should not change practice or introduce new practice issues. The Board also observed that the amendments will result in accounting that is generally consistent with the accounting in Topic 840 and that structuring of immaterial variable payments was not identified as a practice issue under Topic 840.

BC19. The Board also decided to extend the lessor's classification requirements for a lease with variable payments and a day-one loss to a direct financing lease. Although outreach with practitioners indicated that direct financing leases typically do not have those characteristics, the Board concluded that, for consistency, the amendments in this Update also should apply to direct financing leases. The Board also emphasized that introducing selling profits or selling losses on direct financing leases in Topic 842 necessitated this expansion.

BC20. The Board acknowledged that the amendments in this Update will result in a lessor classifying more leases as operating leases (as opposed to sales-type leases or direct financing leases). Consequently, leases that otherwise would not qualify for the practical expedient in paragraph 842-10-15-42A to combine lease and nonlease components and account for them as a single component may now qualify for that expedient. This is because the scope of the expedient is limited to operating leases. The Board concluded that this will occur only in situations in which the pattern of transfer of the nonlease component is over time (consistent with the pattern of transfer of benefits from a lessor to a lessee in an operating lease over the lease term) and not at a point in time (for example, when the

nonlease component is a consumable product), consistent with the current requirements in paragraph 842-10-15-42A.

BC21. Additionally, the Board acknowledged that more leases being classified as operating by lessors may result in more sale and leaseback transactions accounted for by buyer-lessors (not seller-lessees) as successful purchases of the asset. This is because the guidance on sale and leaseback transactions in Subtopic 842-40, Leases—Sale and Leaseback Transactions, considers classification to determine whether the transaction is accounted for as a successful sale. A buyer-lessor is not considered to have obtained control of the underlying asset if the leaseback is classified as sales-type but is considered to have obtained control if the leaseback is classified as operating or direct financing and the other criteria for a sale in paragraphs 842-40-25-1 through 25-3 are met. For a buyer-lessor, the difference in accounting for the sale and leaseback transaction as a successful purchase of the asset is primarily balance sheet classification. Furthermore, the Board emphasized that the successful sale accounting by a lessor will have no effect on lessee accounting because the amendments in paragraph 842-10-25-3A will not affect the principles related to transfer of control in Topic 842 (or lease classification criteria in paragraph 842-10-25-2) but, rather, will be a practical solution only for lessors with a day-one loss issue. Specifically, regardless of a lessor's accounting, if a lessee classifies a lease as a finance lease, the lessee cannot account for the transfer of the underlying asset in a sale and leaseback transaction as a successful sale. Rather, it will account for the transaction as a failed sale and leaseback transaction by not derecognizing the underlying asset and recognizing a financial liability for any amounts received.

BC22. As is the case with any final Update, the Board considered whether the amendments in this Update are significantly different from those in the proposed Update and, if so, whether the amendments should have been reexposed for public comment. Specifically, the Board considered whether (a) the financial reporting results differ significantly from that which would have been reported under the proposed Update (including input sought by the Board in the Questions for Respondents and the basis for conclusions) and (b) the amendments in this Update revert to existing GAAP or are responding to suggestions made and supported by a significant number of respondents and not opposed by any significant stakeholder group.

BC23. The Board solicited stakeholder feedback on the appropriateness of the “predominant” threshold by including a specific question in the proposed Update about that threshold and through subsequent supplemental outreach with practitioners and industry preparer groups. On the basis of that feedback, the Board concluded that the “predominant” threshold for variable payments was an arbitrary and unnecessary threshold inserted in an attempt to provide a practical solution to the day-one loss issue and did not fully address the issue it intended to solve (operating lease classification for all leases with the day-one loss issue). Therefore, the Board concluded that not requiring a threshold level for variable payments provides users of financial statements with better and more comparable

information, is broadly responsive to stakeholder feedback (see paragraphs BC13 through BC15 for more detail on stakeholder feedback), and improves the classification criterion in paragraph 842-10-25-3A.

BC24. In considering whether the amendments in this Update have previously been exposed for public comment, the Board noted that the amendments in this Update align the financial reporting outcomes more closely to those achieved under the application of a classification criterion in previous GAAP (paragraph 840-10-25-45(b)) for lessors with the day-one loss issue. The Board emphasized that such an alignment was a primary objective of the proposed Update. The Board acknowledged that although additional outreach with practitioners indicated that there may be some inconsistencies in interpreting the lessor classification criterion in that paragraph in Topic 840, the requirements in this Update are clear and can be consistently applied. Because Topic 842 was not intended to significantly change lessor accounting, the Board concluded that reverting to outcomes that are consistent with those achieved through the application of Topic 840 is not creating “new GAAP.” The Board also noted that a significant number of entities have yet to adopt Topic 842 and for those entities the amendments in this Update will result in accounting outcomes that are consistent with how the Board understands Topic 840 is generally interpreted in practice, thus resulting in little or no change for those entities.

BC25. On the basis of feedback collected from stakeholders (which included those that represent a significant portion of stakeholders affected by this issue) through comment letters and subsequent outreach and consideration of its original intent of issuing the proposed Update, the Board concluded that it had sufficient information to finalize the amendments in this Update. The Board’s conclusion and its application of judgment are consistent with prior application of the factors considered when assessing reexposure. The Board noted that changes of equal or greater significance (when considering both the number of affected entities and the change in outcomes compared with both current practice and the proposed requirements of a proposed Update) occur frequently in the redeliberation process and have not been viewed previously to call into question the Board’s conclusion on reexposure. The Board noted that more significant changes have been incorporated by the Board in numerous Updates and the level of comment letter support for the specific change was less than the support expressed by respondents in the project leading to the issuance of this Update. Examples include:

- a. Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, for example, changes made to the lessor model intended to align lessor’s accounting with Topic 606, Revenue from Contracts with Customers, including the elimination of the provisions in Topic 840 that resulted in the need for this Update
- b. Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, for example, vintage disclosure requirements, the model for

- purchased financial assets with credit deterioration, and changes to the accounting for available-for-sale debt securities
- c. Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, for example, the last-of-layer hedging requirements
 - d. The forthcoming Update on government assistance disclosures, specifically, the significant changes to the scope of the project from the proposed Accounting Standards Update, *Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance*.

Effective Date and Transition

BC26. The amendments in this Update amend Topic 842, which has different effective dates for public business entities and most entities other than public business entities. The Board decided that the amendments are effective for fiscal years beginning after December 15, 2021, for all entities, and interim periods within those fiscal years for public business entities and interim periods within fiscal years beginning after December 15, 2022, for all other entities.

BC27. The Board decided that entities that have not adopted Topic 842 on or before the issuance date of this Update should follow the transition requirements in paragraph 842-10-65-1 of Topic 842 so that those entities do not perform a separate transition to apply the amendments in this Update. That transition is either (a) retrospective to each prior period presented in the financial statements with the cumulative effect of transition recognized at the beginning of the earliest period presented or (b) retrospective at the beginning of the period of adoption with a cumulative effect of transition recognized at the beginning of the period of adoption. The Board decided that entities that have adopted Topic 842 before the issuance date of this Update have the option to apply the amendments either (a) retrospectively to leases that commence or are modified on or after the adoption of Update 2016-02 or (b) prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments in this Update.

BC28. Earlier application is permitted. The Board decided that applying retrospective transition to leases that commence or are modified on or after the adoption of the original Update on leases (as opposed to leases existing as of the beginning of the earliest comparative period presented) is appropriate and provides decision-useful information. This is because stakeholders emphasized that the day-one loss issue is related to a classification criterion in Topic 840 that was not retained in Topic 842. Therefore, the day-one loss issue would mostly be present in accounting for lease arrangements after the adoption of Topic 842 and not under Topic 840.

Amendments to the GAAP Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the “GAAP Taxonomy”). Those improvements, which will be incorporated into the proposed 2022 GAAP Taxonomy, are available through [GAAP Taxonomy Improvements](#) provided at www.fasb.org, and finalized as part of the annual release process.