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Accounting

Lessors'

ASU 2021-05: Lessors' accounting for certain leases with variable payments

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The Financial Accounting Standards Board recently issued ASU 2021-05 to amend ASC 842 so that lessors are no longer required to recognize a selling loss upon commencement of a lease with variable lease payments that, prior to the amendments, would have been classified as a sales-type or direct financing lease.

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Under the amended guidance, a lessor must classify as an operating lease any lease that would otherwise be classified as a sales-type or direct financing lease and that would result in the recognition of a selling loss at lease commencement, provided that the lease includes variable lease payments that do not depend on an index or rate.

Background

To account for a sales-type or direct financing lease under ASC 842, a lessor must derecognize the underlying asset and recognize a net investment in the lease. The net investment in the lease is initially measured, in part, based on the present value of the lease payments not yet received from the lessee. The "lease payments" reflected in the initial measurement of the net investment in the lease exclude variable lease payments that are not based on an index or rate (for example, payments based on future sales of output or future purchases of supplies).

Sales-type and direct financing leases may include substantial variable lease payments that are not based on an index or rate, such that the lessor's initial net investment in the lease is less than the carrying amount of the underlying asset (net of any unguaranteed residual asset). Prior to ASU 2021-05, a lessor in this situation would recognize a selling loss at the lease commencement date, or a "day one loss.

The Financial Accounting Standards Board heard from many stakeholders that a lessor's recognition of a day one loss at the commencement date of a sales-type or direct financing lease typically does not reflect the lease's underlying economics. In response, the Board initiated a project to address this issue, culminating in the issuance of ASU 2021-05.

Amendments to ASC 842

ASU 2021-05 amends the lessor lease classification guidance in ASC 842 for leases that include any amount of variable lease payments that are not based on an index or rate.

If such a lease meets the criteria in ASC 842-10-25-2 through 25-3 for classification as either a sales-type or direct financing lease, and application of the sales-type or direct financing lease recognition guidance would result in recognition of a selling loss, then the amendments require the lessor to classify the lease as an operating lease.

Accounting for affected leases

Under ASC 842, for operating leases a lessor neither derecognizes the underlying asset nor recognizes a net investment in the lease, and instead recognizes the "lease payments" on a straight-line basis over the lease term. Variable lease payments not based on an index or rate are excluded from the "lease payments" at commencement and are instead recognized in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

For leases classified as operating leases under the amended guidance, a lessor does not recognize a day one loss that would have been recognized if the lease were classified as a sales-type or direct financing lease.

Effective date

For public business entities and certain not-for-profit entities and employee benefit plans that have adopted ASC 842 as of July 19, 2021, the amendments in ASU 2021-05 are effective for fiscal years beginning after Dec 15, 2021, and for interim periods within those fiscal years.

For all other entities that have adopted ASC 842 as of July 19, 2021, the amendments in ASU 2021-05 are effective for fiscal years beginning after Dec 15, 2021, and for interim periods within fiscal years beginning after Dec 15, 2022.

All entities that have adopted ASC 842 as of July 19, 2021, are permitted to early adopt the amendments in ASU 2021-05.

The amendments in ASU 2021-05 are effective as of the same date as the guidance in ASC 842 for entities that have not adopted ASC 842 as of July 19, 2021.

Transition

Entities that have adopted ASC 842 as of July 19, 2021, may use either of the following transition methods:

- retrospective application to leases that commenced or were modified (except for modifications that meet the conditions in ASC 842-10-25-8) after the beginning of the period in which ASC 842 was adopted
- prospective application to leases that commence or are modified (except for modifications that meet the conditions in ASC 842-10-25-8) subsequent to the date the amendments in ASU 2021-05 are first applied (that is, no earlier than July 19, 2021)

Entities that apply the retrospective transition method must disclose the applicable transition information required by ASC 250, except for the requirements in ASC 250-10-50-1(b)(2) and ASC 250-10-50-3. The cumulative effect of applying the amendments in ASU 2021-05 on retained earnings or other components of equity or net assets must be disclosed as of the beginning of the earliest period presented, but not before the date when ASC 842 was adopted.

Entities that apply the prospective transition method must disclose the following information:

- the nature of, and reason for, the change in accounting principle
- the transition method
- a qualitative description of the financial statement line items affected by the change

For entities that have not adopted ASC 842 as of July 19, 2021, the amendments in ASU 2021-05 are subject to the same transition guidance that applies to ASC 842.

Source: *Grant Thornton Snapshot July 22, 2021*

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