FINANCIAL ACCOUNTING STANDARDS BOARD

Public Roundtable Meeting
Leases Implementation
Friday, September 18, 2020
Session 1: 8:30 a.m. to 12:00 p.m.
Session 2: 1:00 p.m. to 4:30 p.m.

Financial Accounting Standards Board
Virtual Meeting via Zoom

AGENDA

SESSION 1	SESSION 2	TOPIC FOR DISCUSSION
8:30 a.m.	1:00 p.m.	Welcome and Introduction
8:35 a.m.	1:05 p.m.	Lessee Application of Rate Implicit in the Lease
9:05 a.m.	1:35 p.m.	Lessee Application of Incremental Borrowing Rate
9:50 a.m.	2:20 p.m.	Embedded Leases
10:35 a.m.	3:05 p.m.	Break
10:45 a.m.	3:15 p.m.	Lease Modifications
11:30 a.m.	4:00 p.m.	Lessee Allocation of Fixed and Variable Payments
12:00 p.m.	4:30 p.m.	Closing

TOPICS FOR DISCUSSION

TOPIC 1: Lessee Application of Rate Implicit in the Lease

Issue Background

1. This issue relates to the application of the discount rate guidance in Topic 842, Leases, for lessees. A lessee's determination of the discount rate is essential because it directly affects lease classification (operating or finance) and the measurement of a lessee's lease liability and corresponding right-of-use (ROU) asset. This memo will consider whether additional or amended guidance is needed for lessees to apply the guidance on the rate implicit in the lease. The Board received a formal request to add this issue to its technical agenda from a large accounting firm (see Appendix A). Specifically, the issue is whether the lessee either:

   (a) Has the ability to apply the rate implicit in a lease, considering the existing lessor specific assumptions in the definition of rate implicit in a lease, or

   (b) Should default to its incremental borrowing rate (IBR), unless the lessor provides the lessee with the rate and the underlying inputs can be substantiated.

   The agenda request asserts that the rate implicit in the lease and the IBR can significantly differ, such that the rate implicit in the lease often will be significantly greater than the IBR. Therefore, using IBR may naturally result in a significantly greater lease liability and ROU asset.

Applicable Accounting Guidance and Current Practice

2. Rate implicit in the lease (hereinafter referred to as implicit rate) is defined in Topic 842 as follows:

   > The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor.

3. IBR is defined in Topic 842 as "the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment."

4. Paragraph 842-20-30-3 states that "a lessee should use the rate implicit in the lease whenever that rate is *readily determinable*. If the rate implicit in the lease is not readily determinable, a lessee shall use its

incremental borrowing rate" (emphasis added). This guidance is similar to paragraph 26 in IFRS 16, *Leases,* which states, in part, that "the lease payments shall be discounted using the interest rate implicit in the lease if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate." The submitter asserts that stakeholders have a difficult time interpreting what the Board intended in Topic 842 about using a readily determinable threshold and, as a result, diverse views exist in practice. The implicit rate includes lessor-specific assumptions of (a) the lessor's expected residual value of the underlying asset, (b) investment tax credits expected to be realized and retained by the lessor, and (c) deferred initial direct costs. Therefore, many stakeholders believe that the implicit rate is readily determinable only when the lessor provides the lessee with the implicit rate and the inputs that the lessor used can be substantiated (hereinafter referred to as View A). Others believe that the implicit rate can be readily determinable when there is publicly available information for all significant inputs of the implicit rate, and it would be reasonable to expect that the lessor would have used those inputs in its calculation. In those situations, it is expected that the lessee can readily determine the implicit rate (hereinafter referred to as View B).

5. The submitter asserts that confusion on how to apply "readily determinable" may stem from historical practice under Topic 840, Leases. Topic 840 used similar (but not exact) terms to define implicit rate. Historically, lessees have defaulted (and practitioners have supported this practice) to using IBR as the discount rate for classification and measurement. This is because paragraph 840-10-25-31 required the lessee to use the implicit rate unless "(a) it is practicable for the lessee to learn the implicit rate computed by the lessor [and] (b) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate." The requirement that the implicit rate be less than the IBR was removed in Topic 842. Consequently, the submitter believes that it is unclear whether "readily determinable" in Topic 842 is intended to be the same as it being "practicable" for the lessee to learn the implicit rate computed by the lessor under Topic 840.

6. Because practice has supported defaulting to IBR under Topic 840, lessees were not required by auditors to initially determine whether they could learn the implicit rate calculated by the lessor before using IBR. This reduced complexity and eliminated the necessity of a process to substantiate whether the implicit rate could be learned and used as the lessee's discount rate.

7. Opponents of View B believe that that view would result in lessees being required to have processes in place to determine whether the implicit rate can be readily determined before the lessee would be allowed to use its IBR. In other words, lessees would be unable to default to IBR unless they could substantiate that the implicit rate was not readily determinable. Requiring additional processes for determining the discount rate, given the significant processes already required to determine IBR

(because IBR is now based on a collateralized rate), would increase the cost and complexity of applying Topic 842.

Summary of Outreach and Research

Outreach

8. The staff performed outreach with the large accounting firms to understand their interpretations of the guidance and the pervasiveness of the issue in the agenda request. Specifically, the staff asked whether any of their clients had requested to estimate the implicit rate, consistent with View B. The staff also held various calls with the Securities and Exchange Commission (SEC) staff.

9. All of the firms except for the submitter interpreted the guidance consistent with View A. If an approach such as View B was called for, the firms stated that they would require their clients to establish processes to determine their ability to estimate the implicit rate (or to substantiate that they are unable to make an estimation). Those firms interpret the Topic 842 guidance on “readily determinable” as consistent with Topic 840; they did not consider the Board’s intent when developing Topic 842 to be a change in practice. They asserted that, absent knowing the lessor-specific inputs (obtained directly from the lessor and able to be substantiated), the implicit rate is not readily determinable by the lessee, and IBR should be used. They observe that practice is well established, that the guidance is well understood, and that a change could be disruptive to the system.

10. The submitter highlighted to the staff that Topic 842 clearly articulates that a lessee’s discount rate is required to be the implicit rate if that rate is readily determinable and that using the implicit rate best reflects the economics of a leasing transaction. Therefore, they asked that the Board clarify the application of “readily determinable.” They stated that they had a client that had requested to estimate the implicit rate using a method consistent with View B. That is, the lessor did not provide the lessee with its implicit rate (along with the inputs), but the client believed that it could gather and substantiate the information needed to reliably estimate the implicit rate. Like the other firms, if the Board’s interpretation of “readily determinable" is consistent with View B, the submitter also would require their clients to implement new processes to substantiate that the implicit rate could not be estimated before allowing their clients to use their IBR.

11. The submitter proposed that the Board provide an option for lessees to determine and use the implicit rate even if they did not know the exact inputs used by the lessor. Optionality was proposed to avoid further complexity and additional costs and processes in the system. Under this option, if the rate and inputs used by the lessee are not received from the lessor, the lessee could use an estimate of the

implicit rate if that rate can be reliably estimated. However, instead of estimating the rate implicit in the lease, the lessee could choose (as a practical expedient by class of underlying asset) to use its IBR. Under this proposal, if the implicit rate cannot be reliably estimated, the lessee would continue to be required to use its IBR (or could elect to use the risk-free rate for all leases if it is a nonpublic entity; see Memo 3 on IBR).

12. The staff has continued to monitor and discuss whether this issue has become more pervasive with the firms; there has been minimal changes in feedback from that originally obtained. To date, no additional requests to address this issue have been received, verbal or written, other than verbally from the submitter’s client. In recent outreach, the staff explored the potential effect of removing the guidance that requires that lessees use the rate implicit in the lease if it is readily determinable. The large accounting firms were broadly against such an amendment because they believe that the implicit rate represents the lessee’s cost to borrow under the lease contract and, thus, provides users with the best information. Additionally, the firms noted that the rate implicit in the lease could be known or readily determinable by a subset of lessees, such as lessees who are also lessors, lessees in sale-leaseback or synthetic lease transactions, related-party lessees, and equipment lessees when published residual values are available. In those circumstances, the firms stated that the implicit rate is a better representation of the economics of the lease than IBR.

Research

13. The staff identified and read all memos and meeting minutes on discount rates to determine (a) whether the Board had previous discussions regarding the change in language for implicit rate from Topic 840 to Topic 842 and (b) if there was any indication that the Board sought to change how lessees applied the discount rate guidance in practice. The staff also discussed the issue with former Leases project staff for similar reasons. On the basis of this review, the staff located a prior staff assertion that it would be rare that a lessee would use the implicit rate because lessees generally are not privy to lessor-specific inputs and assumptions. Additionally, one Board member previously questioned why the “readily determinable” language was included in Topic 842 given their belief that lessees will almost always default to IBR for the reasons noted in the preceding sentence. Discussions with former project staff indicated that there was no conscious effort to change how practice applied the discount rate guidance; it was expected that practice would continue to be consistent with Topic 840 as it relates to this issue.

Potential Alternatives

14. The following are potential alternatives for this issue:

    (a) Alternative A – No change to Topic 842

    (b) Alternative B – Eliminate the requirement for lessees to consider the implicit rate in Topic 842

    (c) Alternative C – Provide an option in Topic 842 for lessees to use the implicit rate (with a default to IBR).

15. The staff is not proposing an alternative that would lower the threshold for when lessees are required to use the implicit rate in practice. For example, the staff would not recommend adding assertions that the implicit rate is considered readily determinable when there is publicly available information for all significant inputs of the implicit rate and it would be reasonable to expect that the lessor would have used those inputs in its calculation (one of the suggestions from the submitter). The primary reason for forgoing this alternative is the staff's concern that lessees would then be required to establish and maintain robust processes to substantiate that they could not estimate the implicit rate before using IBR. Practice seems well established and consistent in applying the discount rate guidance under both Topic 840 and Topic 842.

16. Lessees are almost always required to use IBR, primarily because of the position taken that the implicit rate is not readily determinable unless the lessor provides the lessee with the implicit rate and the inputs that the lessor used in determining the implicit rate can be sufficiently substantiated. Therefore, the staff excluded alternatives that would significantly disrupt practice and require all lessees to establish processes to first substantiate that they cannot determine the implicit rate before using IBR. Note that practice has taken this position under Topic 842 primarily because the lessor-specific assumptions included in the Topic 842 definition of implicit rate (the lessor's expected residual value of the underlying asset, investment tax credits expected to be realized and retained by the lessor, and deferred initial direct costs) are not expected to be sufficiently available to the lessee.

Staff Observations

Alternative A – No Change to Topic 842

17. Outreach and research indicate that practice is consistently applying the discount rate guidance for purposes of lease classification and measurement under both Topic 840 and Topic 842 and that this issue is not pervasive. Research also indicates that it was not the Board's intent to change how lessees determine whether they use the implicit rate or IBR. That is, unless the lessee was provided with the implicit rate by the lessor and the inputs can be substantiated, the Board seemingly expected that the

lessee would use its IBR for purposes of classification and measurement. Practice historically has not allowed estimation of the implicit rate (without access to and substantiation of the information); this reduces the complexity in determining the lessee's discount rate. It also eliminates the need for lessees to add robust processes to substantiate that the implicit rate cannot be estimated. On the basis of feedback received, lessees have not supported a change to Topic 842; lessees do not want to implement additional processes to substantiate whether they can reliably estimate the implicit rate rather, they would prefer to continue to default to their IBR. It is important to note that lessees have already spent significant time implementing processes to estimate IBR, given that the Topic 842 definition of IBR changed to a "collateralized" rate. Therefore, the staff expects that making no changes to the guidance for this issue would be readily accepted by most stakeholders and that practice would continue to consistently apply the lessee's discount rate guidance. This alternative keeps the lessee discount rate guidance consistent with that in IFRS 16.

Alternative B – Eliminate the Requirement for Lessees to Consider the Implicit Rate in Topic 842

18. Because Alternative A would not change or clarify the application of the lessee discount rate guidance, it leaves the question about why the Board requires the lessee to use the implicit rate when it is readily determinable. In other words, if the Board intended for practice to continue to default to IBR in almost all circumstances, why it is necessary to continue to require the use of the implicit rate if that rate is readily determinable? The staff acknowledges that the implicit rate is effectively the rate that the lessor charges the lessee and may be considered to reflect the lessee's economic cost in the lease. However, the existing language seems to be the source of some confusion in determining when implicit rate is readily determinable and should be used by the lessee. Alternative B would eliminate any reference to implicit rate in lessee guidance and, thus, any confusion of when it is appropriate to use that rate. The staff acknowledges that situations can exist in which the implicit rate may be readily determinable (see paragraph 12 for examples of those situations). Additionally, the staff observes that using the implicit rate for lessee accounting results in symmetry in classification and measurement between the lessor and the lessee. However, the staff notes that it was not the Board's objective to achieve that symmetry. Specifically, paragraph BC90 of Accounting Standards Update No. 2016-02, *Leases (Topic 842),* states, that "having considered all of the feedback received throughout the project, including that from financial statement users, the Board concluded that achieving symmetry between the statements of financial position of lessees and lessors was not a paramount objective of Topic 842."

19. IFRS 16 has language similar to Topic 842 regarding using the implicit rate if readily determinable. Eliminating the requirement to consider the implicit rate results in nonconvergence with IFRS 16.

Alternative C – Provide an Option in Topic 842 for Lessees to Use the Implicit Rate (with a Default to IBR)

20. Alternative C would provide lessees with an option to use the implicit rate if certain conditions are met (the conditions would need to be developed). The staff thinks that introducing an option avoids the costs and complexity of requiring all lessees to establish and maintain processes to substantiate whether they can determine the implicit rate given all of the lessor-specific assumptions in that rate. If developed, it is expected that this alternative would allow lessees to use the implicit rate more often than they currently are or to use the two rates interchangeably.

21. Under this alternative, the staff would propose eliminating "readily determinable" from the guidance because practice has already interpreted that as an extremely high hurdle for lessees to overcome to use the implicit rate. Consideration could be given to changing the guidance to include a lower threshold such as "reliably estimable." This language would be consistent with other areas of GAAP under which significant estimates are commonly made to measure amounts recognized in the financial statements. However, the staff acknowledges that any change to Topic 842 may require additional interpretative guidance. The staff also observes that Topic 842 includes a number of options and practical expedients to reduce the costs and complexity of applying the guidance and for transition. Optionality creates noncomparability, potentially reducing the overall benefits of the standard. It also can create complexity because entities must consider and evaluate the potential choices. Additionally, it may be challenging to justify the benefits of providing a choice for an issue that has not been pervasive. Finally, this alternative would result in nonconvergence with the IFRS 16 lessee discount rate guidance.

Questions for Discussion
1. What are your views on the issue discussed in this memo?
2. Are there any other alternatives to address the issue?
3. What alternative do you support and why?

TOPIC 2: Lessee Application of Incremental Borrowing Rate

Issue Background

1. This issue relates to the lessee's application of the discount rate guidance on the incremental borrowing rate (IBR) in Topic 842, Leases. The Board has been made aware that public business entity (PBE) lessees spent a significant amount of time and effort during the transition to Topic 842 applying the IBR guidance. Lessees use their IBR to classify and measure the leases in their portfolios.

Applicable Accounting Guidance

2. IBR is defined in Topic 842 as follows:

> The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

3. In Topic 840, Leases, IBR was defined as follows:

> The rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset. This definition does not proscribe the lessee's use of a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

4. Assuming that the rate implicit in the lease is not readily determinable, under both Topic 840 and Topic 842, a lessee needs to determine IBR to decide whether to classify a lease as an operating lease or a finance lease (capital lease under Topic 840). Specifically, paragraph 842-10-25-2(d) requires that a lessee classify a lease as a finance lease if "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" (often referred to as "the present value test"). Additionally, paragraph 842-20-30-1 requires a lessee to initially measure "the lease liability at the *present value* of the **lease payments** not yet paid, discounted using the **discount rate for the lease** at lease commencement" (emphasis added). Finally, certain lease modifications and remeasurement events require a lessee to subsequently remeasure the lease liability using an updated discount rate as of the modification or remeasurement date. The discount rate ordinarily used by lessees that are PBEs is IBR (see separate memo about the rate implicit in the lease).

5. Paragraph 842-20-30-3 allows lessees that are not PBEs to use a risk-free rate discount rate, determined using a period comparable with that of the lease term, as an accounting policy election for all leases. The Board concluded that it would be too costly for some of those entities to identify an IBR that reflects the lessee's credit and the effect of the underlying asset as collateral. Broadly, entities that are not PBEs supported this option (note that it was originally proposed in the 2013 Exposure Draft).

6. Paragraph 842-20-50-3(c)(3) requires lessees to disclose information about significant assumptions and judgments made in determining the discount rate for the lease. Additionally, paragraph 842-20-50-4(g)(3) requires lessees to disclose their weighted-average discount rate, separately for operating and finance leases.

7. Other Topics in the Codification prescribe specific rates for discounting liabilities. The Pending Content in Accounting Standards Update No. 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts,* which amends Topic 944, provides the following measurement guidance in paragraph 944-40-30-9 for the liability for future policy benefits associated with long-duration contracts:

> *The liability for future policy benefits shall be discounted using an upper-medium grade (low-credit-risk) fixed-income instrument yield.* An insurance entity shall consider reliable information in estimating the upper-medium grade (low-credit-risk) fixed-income instrument yield that reflects the duration characteristics of the liability for future policy benefits (see paragraph 944-40-55-13E). An insurance entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs in determining the discount rate assumption. [Emphasis added.]

8. This rate has been generally interpreted as an A rate.

9. In Topic 715, Compensation—Retirement Benefits, paragraph 715-30-35-43 provides the following measurement guidance for certain pension obligations:

> Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of **annuity contracts** that could be used to effect **settlement** of the obligation (including information about available annuity rates published by the Pension Benefit Guaranty Corporation). *In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits.* Assumed discount rates are used in measurements of the projected, accumulated, and vested benefit obligations and the service and interest cost components of net periodic pension cost. [Emphasis added.]

10. This rate has been generally interpreted as an AA rate.

11. In Subtopic 410-20, Asset Retirement and Environmental Obligations—Asset Retirement Obligations, paragraph 410-20-30-1 discusses the use of a credit-adjusted risk free-rate to discount expected cash flows for an asset retirement obligation:

> This implementation guidance illustrates paragraph 410-20-30-1. *An entity shall discount expected cash flows using an interest rate that equates to a risk-free interest rate adjusted for the effect of its credit standing (a credit-adjusted risk-free rate). In determining the adjustment for the effect of its credit standing, an entity should consider the effects of all terms, collateral, and existing guarantees on the fair value of the liability*. [Emphasis added.]

12. This rate has generally been interpreted as similar to an IBR in practice.

Summary of Outreach

13. This issue was discussed with the large accounting firms, certain public company preparers and preparer groups, industry groups, and many FASB advisory groups. Because the amendments in Topic 842 require lessees to recognize operating lease liabilities at a discounted amount (generally, the lease liability is based on the present value of lease payments not yet paid, discounted at an appropriate rate), the emphasis on the preciseness of IBR has been amplified. Additionally, Topic 842 changed the definition of IBR from Topic 840 in that it requires IBR to reflect a "collateralized" borrowing rate that could be obtained in a "similar economic environment." The large accounting firms have supplied in-depth publications detailing the methods that entities could use for determining IBR under Topic 842. Notwithstanding the extensiveness of the published information and the complexity involved, the level of required precision in determining IBR is correlated to the expected materiality of the entity's lease liabilities.

14. All PBEs have adopted Topic 842 and many have established robust processes during their transition to determine and substantiate IBR. It is expected that those processes will be repeatable. However, some are concerned that significant ongoing cost and effort may be required to determine and substantiate IBR for leases entered into after transition, subsequently modified, or required to be remeasured. Moreover, most nonpublic business entities have not yet applied Topic 842.

15. Many outreach participants asserted that although PBEs incurred significant costs in establishing processes for determining IBR under Topic 842, those processes are expected to be repeatable, which will mitigate the risk of ongoing complexity and will decrease the ongoing costs associated with determining IBR. Therefore, those stakeholders caution that any significant changes to the definition of IBR (such as reverting to the Topic 840 definition) may be disruptive to PBEs that have successfully

adopted Topic 842. In other words, now that the processes and procedures are in place, any significant changes may be disruptive to a PBEs processes and could result in additional costs and effort. Participants also noted that the definition of IBR is currently converged with IFRS 16, *Leases.* Any changes that result in a difference between IFRS Standards and Topic 842 could cause issues for global entities that report in under both IFRS Standards and GAAP.

16. Unlike PBEs, nonpublic entities are given an option. They can elect an accounting policy to use a risk-free rate for classification and measurement. Separately, some nonpublic stakeholders have expressed concern about the option to use the risk-free rate because of how low the risk-free rate is in comparison with other rates because the discounting effect will inherently result in a higher lease liability. For nonpublic entities that forego the option to use a risk-free rate, determining IBR is expected to be more difficult and costly. This is because, typically, nonpublic entities do not have sophisticated treasury operations or readily available information (such as quoted or comparable credit spreads) to use in developing an IBR. Therefore, they may have to engage external valuation experts to comply with the Topic 842 IBR requirements, which would be an added cost for those entities under Topic 842. Consequently, certain nonpublic entity stakeholders requested that the Board (a) consider whether changes could be made to the IBR definition to make it easier to apply or (b) provide a different rate that nonpublic entities can elect to apply instead of IBR or the risk-free rate.

17. Certain Board members expressed concern about the amount of time and effort that stakeholders have spent to determine and substantiate IBR, particularly given that the discount rate for operating leases does not affect earnings. Therefore, they requested that the staff consider options to reduce complexity and obtain additional feedback on if, and how, that can be accomplished.

18. The staff notes that other Topics such as Topic 944 and Topic 715 prescribe the use of specific rates in discounting liabilities. Therefore, one approach that the staff is considering and seeking feedback on is whether lessees should have an option to use a specific rate for their lease classification and measurement. The staff notes that other Topics such as Topic 410, Asset Retirement and Environmental Obligations, prescribe a discount rate (a credit-adjusted risk-free rate, which is similar to an IBR) to discount expected cash flows.

Potential Alternatives

19. The following are potential preliminary alternatives for this issue:

    (a) Alternative A – No changes to Topic 842

    (b) Alternative B – Provide an option that allows all lessees (PBEs and nonpublic business entities) to use a specific rate instead of IBR.

Staff Observations

Alternative A – No Changes to Topic 842

20. Although outreach and research indicate that many PBEs incurred significant costs to establish robust processes for determining IBR when transitioning to Topic 842, it is expected that those processes are repeatable. This means that a high likelihood exists that the costs to determine the IBR, as defined in Topic 842, will be reduced on a go-forward basis for PBEs when leases are added, modified, or are required to be remeasured.

21. The definition of IBR has a conceptual basis. A lease is "collateralized" by the underlying asset explicitly identified or implied by a contract. If the lessee does not pay, the lessor has the right to recover its underlying asset, consistent with a bank having rights to repossess a home if a borrower does not pay its mortgage. Amending the definition of IBR to remove or amend "collateralized" (because this term has been communicated as causing some of the complexity related to IBR) or prescribing a specific rate (see Alternative B) could result in a rate that is inconsistent with a rate that the lessee could borrow at under similar terms, given their specific credit standing and the effect of the collateral from the underlying asset.

22. Although the discount rate used to measure operating leases has no effect on earnings, it is important for both lease classification and measurement of the lease liability (and, by extension, the right-of-use asset) on a lessee's balance sheet. During the development of Topic 842, it was important to the Board that the amounts recognized on the balance sheet represent the economics of the lease transaction, that is, consistent with that of a borrowing. Using an IBR that reflects a rate that a lessee would pay in a borrowing arrangement with similar terms achieves that objective.

23. Amounts recognized in the financial statements for finance leases are different from operating leases, particularly in the income statement. In an operating lease, total undiscounted lease cost is recognized on a straight-line basis. However, for finance leases, interest expense is recognized using the interest method, calculated using the IBR, resulting in total interest expense recognized being greater in the earlier years of the lease and less in the later years. IBR is directly correlated with the amount of interest expense recognized in earnings for finance leases. Therefore, to recognize an interest expense that reflects a borrowing, it is important that the expense be determined based on a representative borrowing rate. Allowing all lessees to use a specific rate (for example, an A rating; see Alternative B) regardless of their credit standing and the collateral effect from the underlying asset would result in an interest expense that may not faithfully represent the economics of the transaction.

24. The Board acknowledged that nonpublic entities would likely encounter issues with determining an IBR that complies with the definition in Topic 842, primarily because those entities typically do not have sophisticated treasury departments, publicly traded debt, and quoted credit spreads that represent the specific credit risk of the lessee. Therefore, the Board provided nonpublic entities with an option, as an entity-wide accounting policy election, to use a risk-free rate instead of IBR. This option allows nonpublic entities to avoid the complexities associated with determining IBR.

Alternative B – Provide an Option That allows All Lessees to Use a Specific Rate, Rather Than IBR

25. Alternative B would provide all entities (PBEs and nonpublic business entities) with an option to use a specified rate (not yet determined) as an accounting policy election instead of the IBR. This would be similar to the Board's use of specific rates in Subtopic 944-40 on claim costs and liabilities for future policy benefits (A rate) and Subtopic 715-30 on defined benefit plans (AA rate), acknowledging that in those standards those specific rates are required to be used (that is, there is no optionality). Allowing lessees to use a specific rate would significantly simplify the lessee's determination of an appropriate discount rate, in much the same way that the Board intended in allowing nonpublic entities to use the risk-free rate. A lessee could easily identify the specific rate (for example, an A rate for the specific term of the lease) through easily accessible, publicly quoted rates. Lessees would still be required to recognize lease liabilities and lease assets for all leases, albeit likely at different amounts than if IBR was used.

26. Under this alternative, there would be no effect on earnings for operating leases. Specifically, regardless of whether IBR or a specified rate is used, the lessee would recognize the same lease cost in earnings (total undiscounted lease payments straight lined over the lease term). In contrast, using a rate that differs from IBR for finance leases would affect the amount recognized in earnings because the interest expense amount determined using the interest method would naturally be different if a different rate is used. Lease classification also may be affected by using a specific rate. The results of the present value test will inevitably differ if a different rate is used, potentially resulting in a different classification than if IBR was used for that test.

27. This alternative proposes to provide all entities (that is, both public and nonpublic) with an option to use a specific rate as opposed to IBR, which may be different from the risk-free rate for nonpublic entities. If this is the case and it is applicable to nonpublic entities as well, it would seem appropriate to replace the risk-free rate with the new specified rate in that circumstance to avoid having two practical expedient rates for nonpublic entities.

28. The staff did not include a separate alternative to solely change the option for nonpublic entities to use the risk-free rate to another specific, higher rate (which would reduce the lease liability and associated

asset). The application of risk-free rate is simple. The staff found no basis to solely amend nonpublic entities' option to use the risk-free rate. Concerns of nonpublic entity stakeholders centered around the consequences (or outcome) of applying the risk-free rate, rather than the costs or benefits of using that rate (or using a higher specific rate). Those consequences (or outcome) could still exist, albeit to a lesser extent, if the Board provides an option for lessees to use another specified rate.

Questions for Discussion
1. What are your views on the issue discussed in this memo?
2. Are there any other alternatives to address the issue?
3. What alternative do you support and why?

TOPIC 3: Embedded Leases

Issue Background

1. This issue relates to the lessee's application of the guidance in Topic 842, Leases, for the accounting for leases embedded in nonlease contracts (hereinafter referred to as embedded leases), such as service contracts. Specifically, entities have raised concerns about the costs and complexities associated with that identification process and questioned whether additional or amended guidance is needed to reduce those costs. The Board has been made aware that public business entity (PBE) lessees spend a significant amount of time and effort, particularly during their transition to Topic 842, to identify embedded leases.

2. Leases, including embedded leases, are currently required to be identified and recognized (or included in disclosures for operating leases) under Topic 840, Leases. However, greater emphasis has been placed on the identification of embedded leases during the implementation of Topic 842 because operating lease liabilities and assets are required to be recognized on a lessee's balance sheet.

Applicable Accounting Guidance

3. Topic 842 provides the following guidance regarding the definition of lease and lease identification:

> **842-10-15-3** A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).
>
> **842-10-15-4** To determine whether a contract conveys the right to control the use of an *identified asset* (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the **period of use**, the customer has both of the following:
>
> a. The *right to obtain substantially all of the economic benefits from use of the identified asset* (see paragraphs 842-10-15-17 through 15-19)
>
> b. The *right to direct the use of the identified asset* (see paragraphs 842-10-15-20 through 15-26).
>
> If the customer in the contract is a joint operation or a joint arrangement, an entity shall consider whether the joint operation or joint arrangement has the right to control the use of an identified asset throughout the period of use. [Emphasis added.]

4. Topic 842 provides additional guidance on determining whether there is an "identified asset" in a contract and whether an entity has "the right to obtain substantially all of the economic benefits" and "the right to direct the use of the identified asset."

5. The legacy guidance in Topic 840 provides the following regarding the definition of lease and lease identification:

> **Lease**
>
> An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.
>
> **840-10-15-6** An arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if *any* of the following conditions is met:
>
> a. The purchaser has the ability or *right to operate* the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines *while obtaining or controlling more than a minor amount of the output* or other utility of the property, plant, or equipment. The purchaser's ability to operate the property, plant, or equipment may be evidenced by (but is not limited to) the purchaser's ability to hire, fire, or replace the property's operator or the purchaser's ability to specify significant operating policies and procedures in the arrangement with the owner-seller having no ability to change such policies and procedures. A requirement to follow prudent operating practices (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment. Similarly, a contractual requirement designed to enable the purchaser to monitor or ensure the seller's compliance with performance, safety, pollution control, or other general standards generally does not establish control over the underlying property, plant, or equipment.
>
> b. The purchaser has the ability or *right to control physical access* to the underlying property, plant, or equipment *while obtaining or controlling more than a minor amount of the output* or other utility of the property, plant, or equipment.
>
> c. Facts and circumstances indicate that it is ***remote*** *that one or more parties other than the purchaser will take more than a minor amount of the output* or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement, *and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor*

> *equal to the current market price* per unit of output as of the time of delivery of the output.
>
> [Emphasis added.]

6. The basis for conclusions of Accounting Standards Update No. 2016-02, *Leases (Topic 842),* includes the Board's considerations and rationale for changing the definition of a lease in Topic 842:

> BC124. The 2010 Exposure Draft essentially retained the definition of a lease and the accompanying requirements in previous GAAP. Many respondents expressed concerns about the population of contracts that would be captured by the proposed requirements (and in particular that some contracts that they viewed as service contracts would be captured). Respondents also identified practice issues in previous GAAP, such as determining when the price that the customer will pay for the output from the asset is contractually fixed per unit of output or equal to the current market price per unit of output, and questioned why the control criteria used in previous GAAP to define a lease were different from the control proposals that were then being developed within the context of revenue recognition and the control principle in Topic 810 on consolidation.
>
> BC125. Accordingly, in the 2013 Exposure Draft, the Board proposed changes to the guidance on the definition of a lease to address those concerns. The 2013 Exposure Draft using a control principle as the means of distinguishing between a service and a lease and to align the principle with that used in other Topics. Respondents generally supported those changes. However, many respondents stressed the increased importance of the definition of a lease, noting that the assessment of whether a contract contains a lease would generally determine whether a customer would recognize lease assets and lease liabilities. Those respondents said that the Board had not provided adequate guidance to support consistent application of the proposed definition to more complicated scenarios.
>
> BC126. Accordingly, Topic 842 generally retains the approach to the definition of a lease that was proposed in the 2013 Exposure Draft, but makes a number of changes to clarify the Board's intentions and reduce the risk of inconsistent application.
>
> BC127. The Board noted that, *in most cases, the assessment of whether a contract contains a lease should be straightforward.* A contract either will fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment. However, the Board added guidance to make it easier for entities to make the lease assessment for more complicated scenarios. [Emphasis added.]

7. While there is no specific threshold for lessees to apply the requirements in Topic 842 for identifying leases, the basis for conclusions of Update 2016-02 provides the following:

> BC122. The Board observed that, in addition to accounting for some leases at a portfolio level, entities will likely be able to adopt *reasonable*

> *capitalization thresholds* below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment). [Emphasis added.]

8. The basis for conclusions for Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*, provides the following related to the practical expedient that allows lessors to combine lease components and nonlease components (if certain criteria are met) and to account for the combined component under Topic 606, Revenue from Contracts with Customers, if the nonlease component is "predominant:"

> BC35. The Board also acknowledged that although the guidance for lessors in the new leases standard was largely derived from the new revenue guidance (such as the guidance on separation and allocation, collectibility, modifications, and so forth), it is not completely aligned. Notwithstanding, the Board was comfortable with allowing stakeholders discretion for determining whether the nonlease component is the predominant component of the combined component. The Board concluded that an entity should be able to reasonably determine which Topic to apply (based on predominance) without having to perform a detailed quantitative analysis or theoretical allocation to each component.

9. The guidance and basis for conclusions in IFRS 16, *Leases,* provide lessees with an optional *exemption from recognizing leases of low value assets:*

> **Paragraph 5** A lessee may elect not to apply the requirements in paragraphs 22–49 to:
>
> (a) short-term leases; and
>
> (b) leases for which the underlying asset is of low value...
>
> BC100 In developing the exemption, the IASB attempted to provide substantive relief to preparers while retaining the benefits of the requirements in IFRS 16 for users of financial statements. The IASB intended the exemption to apply to leases for which the underlying asset, when new, is of low value (such as leases of tablet and personal computers, small items of office furniture and telephones). At the time of reaching decisions about the exemption in 2015, the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of *US$5,000 or less*. A lease will not qualify for the exemption if the nature of the underlying asset is such that, when new, its value is typically not low. The IASB also decided that the outcome of the assessment of whether an underlying asset is of low value should not be affected by the size, nature, or circumstances of the lessee—ie the exemption is based on the value, when new, of the asset being leased; it is not based on the size or nature of the entity that leases the asset.
>
> [Emphasis added.]

10. The basis for conclusions of Update 2016-02 provides the following regarding the single lease classification model and lessee's optional exemption from recognizing leases of low value assets under IFRS 16:

> BC421 IFRS 16 accounts for all leases in the same manner as finance leases, and, in addition to a lessee recognition and measurement exemption for short-term leases, it includes a similar lessee exemption for leases of "small assets" (that is, leases of underlying assets that are individually small, including being of low value, which the basis for conclusions in IFRS 16 indicates are assets of approximately $5,000 or less for all entities). Topic 842 does not include any recognition and measurement exemption for leases of small assets. *In contrast to feedback received from U.S. stakeholders applying GAAP, the following feedback significantly influenced the IASB's decisions enacted in IFRS 16:*
>
> a. IFRS stakeholders generally communicated that *eliminating lease classification would simplify the accounting for leases* because it would remove a key area of judgment and eliminate the need to have a process for determining lease classification.
>
> b. *Many IFRS stakeholders stated that rather than retain a lease classification assessment, the concerns about implementing new systems and processes would be best addressed by exempting high-volume, low-dollar leases from the new recognition and measurement requirements.* In this way, all significant leases would be accounted for in the same manner, but a lessee's systems and processes would, in effect, not need to be able to capture all of the lessee's leases. A lessee would continue to account for high-volume, low-dollar leases in the same manner as operating leases were accounted for in previous IFRS.
>
> [Emphasis added.]

Summary of Outreach

11. Many stakeholders observed that while the changes to the lease definition may have affected certain industries or arrangements—such that an arrangement that was not a lease under Topic 840 would meet the definition of a lease under Topic 842—most arrangements would be leases under both Topics. That said, because Topic 842 requires the recognition of lease liabilities and lease assets for operating leases, entities have more thoroughly analyzed their contracts to identify embedded leases. Specifically, entities have spent a significant amount of time analyzing many different types of contracts (such as services, sales, supply, manufacturing, transportation and warehouse, and construction contracts) to determine whether those contracts contain embedded leases. This has resulted in lessees making significant investments to (a) implement new processes and controls and (b) determine that all material contracts have been reviewed to identify embedded leases. While entities can leverage

processes implemented during transition on an ongoing basis, entities will continue to incur costs to determine that all new contracts have been reviewed to identify embedded leases.

12. Certain financial statement preparers highlighted the practical expedient available to lessors in Topic 842. That practical expedient allows lessors to combine lease components and nonlease components (if certain criteria are met) and to account for the combined component under Topic 606, Revenue from Contracts with Customers, if the nonlease component is "predominant." While the lessor practical expedient would change the classification (not the amount or timing) of revenue recognized in the income statement, there would be no effect on the balance sheet because the underlying asset would remain on the lessor's balance sheet (that is, the lessor determines that the lease is an operating lease). Those stakeholders suggested that the Board provide a similar option for lessees. They recommend that lessees have an option to exclude the embedded lease from the classification, recognition, and measurement requirements in Topic 842 if the embedded lease met a certain threshold (for example, if the lease component was insignificant). That option would require the lessee to account for the full contract in accordance with GAAP applicable to the nonlease component, such as that for a service contract. Note that a similar lessee practical expedient, if provided, would (a) change the classification (not the amount or timing) of expense recognized in the income statement, and, furthermore, (b) result in reduced lease liability recognized by the lessee. Stakeholders acknowledged that adding an option for lessees would not reduce the costs and complexities associated with the lessee's requirements to identify potential embedded leases because lessees would still need to gather the information and assess the lease and nonlease components.

13. Those who support adding an option for lessees suggested different thresholds for the Board to consider (none of which, those stakeholders believe, will materially affect a lessee's balance sheet). For example, a lessee could exclude an embedded lease from its lease accounting if "substantially all" of the consideration in a contract relates to nonlease components. Another suggestion is that a lessee could exclude an embedded lease from its lease accounting if the lease component is "immaterial in the context of the contract." That suggestion leverages guidance in Topic 606 for the identification of an immaterial performance obligation and related revenue recognition. Additionally, a group representing private companies requested that private company lessees be permitted to disregard potential leases (or lease components) if they meet a low value threshold, similar to IFRS 16.

14. Most audit firms that we spoke with stressed that materiality should be the basis for determining whether to account for a lease component under Topic 842, as opposed to establishing a specific dollar threshold through standard setting.

Potential Alternatives

15. When considering potential alternatives, the staff concluded that there are no viable alternatives that would eliminate the lessee's requirement to identify embedded leases. This is because it is not possible to determine whether a lease is material (or meets another threshold) without identifying the existing leases in a lessee's contracts.

16. Therefore, the alternatives consider whether a threshold that would allow a lessee to account for an embedded lease in accordance with the requirements of the nonlease component (for example, the service component) should be provided. The following are alternatives to consider:

    (a) Alternative A – No change to Topic 842

    (b) Alternative B – Option to not apply Topic 842 on the basis of a *qualitative* threshold

    (c) Alternative C – Option to not apply Topic 842 on the basis of a *quantitative* threshold (low-value threshold similar to IFRS 16).

Staff Observations

Alternative A – No Change to Topic 842

17. The staff observes that the stakeholders who have requested an exemption from applying the requirements of Topic 842 have not expressed concerns about the changes in the lease definition. Because the concept of embedded leases is not new under Topic 842, it would seem that an entity would already have some processes and controls in place to review contracts to identify their leases (including embedded leases). However, if more emphasis is being placed on identifying leases because lease liabilities and lease assets are now being recognized for operating leases, entities that have implemented Topic 842 have developed new or more robust processes, at varying costs.

18. Under this alternative, using a materiality threshold as described in the basis for conclusions of Update 2016-02 is sufficient to provide a reasonable application of Topic 842 for identifying if a material lease exists. If an immaterial lease component is not accounted for as a lease under Topic 842, the whole contract would be accounted for in accordance with other GAAP (for example, GAAP applicable to a service contract).

Alternative B – Option to Not Apply Topic 842 on the Basis of a Qualitative Threshold

19. This alternative would provide lessees with an option to exclude embedded leases that meet a certain threshold from the classification, recognition, and measurement requirements of Topic 842. Instead, the whole contract would be accounted for in accordance with GAAP applicable to the nonlease component(s). Stakeholders have preliminarily suggested certain qualitative thresholds that could be

used for the option. Those thresholds would allow a lessee to exclude an embedded lease from lease accounting when:

(a) The lease component is “immaterial in the context a contract.”

(b) The nonlease component is “significant.”

(c) The lease component is not “more than insignificant.”

(d) The nonlease component is “predominant.”

(e) The nonlease component represents “substantially all” of the contract.

20. Potential guidance for this alternative would have to be further developed, including how the threshold could be applied (for example, based on the value of the asset or based on the value of the right of use). Additional outreach and research would be necessary to understand any unintended consequences of this alternative. The goal would be to consider adding a qualitative determination of whether the lease component meets a certain threshold, such that the whole contract could be accounted for in accordance with GAAP applicable to the nonlease component(s). The staff observes that consistent with the Board’s reasoning in providing a lessor expedient for combining lease and nonlease components (see paragraph BC35 of Update 2018-11), a lessee may be able to reasonably determine whether a lease component would meet the threshold without having to perform a detailed quantitative analysis or theoretical allocation to each component. It is important that the threshold not be at a level that compromises the Board’s objective of having material operating leases recognized on balance sheet. As previously stated, this alternative would not alleviate the need for an entity to identify embedded leases.

21. On the basis of outreach feedback, the staff notes that if the practical expedient is provided for lessees, it would change the classification of expense recognized in the income statement but would not change the amount of expense recognized. The staff believes that the practical expedient would maintain the same timing of expense recognition in most cases. However, the staff observes that in some cases the timing of expense recognition may differ under the expedient, for example, in a contract to purchase goods that contains an insignificant lease component.

22. This alternative may be helpful for nonpublic entities, most of whom have not yet adopted Topic 842 and have a delayed effective date. This is because those entities would be able to account for the entire contract in accordance with GAAP applicable to the nonlease component.

Alternative C – Option to Not Apply Topic 842 on the Basis of a Quantitative Threshold (Low-Value Threshold similar to IFRS 16)

23. Consistent with IFRS 16, this alternative would provide lessees with an option to exclude potential leases (including embedded leases) below a specific dollar threshold from the lease accounting requirements. That is, if the value of the underlying asset of a potential lease is less than a certain dollar amount, an entity would not be required to apply Topic 842. Under IFRS 16, that threshold is $5,000. An issue with this alternative is that a single fixed dollar amount may be material to some entities and immaterial to others.

24. The staff observes that the Board had previously considered and dismissed a low value threshold under Topic 842 because the guidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. As discussed in paragraph BC122, the Board observed that a lessee may be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized. Furthermore, as discussed in paragraph BC421, the low value threshold under IFRS 16 was provided to address the concerns raised by IFRS stakeholders who wanted to retain a single lease classification model but needed relief from recognizing and measuring high-volume, low-dollar leases as finance leases.

25. Furthermore, the staff observes that under IFRS 16 lessees that elect the optional recognition and measurement exemption are required to disclose expenses related to leases of low-value assets. This requires robust processes and controls to track and accumulate this information and may not address the concerns raised about the costs and complexities associated with accounting for embedded leases.

Questions for Discussion
1. What are your views on the issue discussed in this memo?
2. Are there any other alternatives to address the issue?
3. What alternative do you support and why?

FINANCIAL ACCOUNTING STANDARDS BOARD

TOPIC 4: Lease Modifications

Issue Background

1. This issue relates to the costs and complexity associated with applying the lease modification guidance in Topic 842, Leases, which is significantly different from the lease modification guidance in Topic 840, Leases. Modification accounting was considered earlier this year when practice raised concerns about a high volume of anticipated lease modifications (lease concessions) because of the effects of the Coronavirus Disease 2019 (COVID-19) pandemic. The staff issued a FASB Staff Question and Answer (Q&A) in April 2020 to address the immediate concerns regarding modification accounting and provide relief for certain lease concessions related to the effects of the COVID-19 pandemic. Additionally, lease modification accounting was added to the leases roundtable agenda to discuss whether certain aspects of that guidance may be improved without compromising the decision usefulness of the information.

2. On the basis of staff outreach with preparers and practitioners, the Board learned that the application of lease modification guidance to certain reductions within the scope of a lease contract (for example, a master lease agreement) that do not have an effect on the economics of the remaining lease components associated with that contract is burdensome and causes unjustified costs and complexity. The Board agreed with that criticism and, in July 2020, decided to add a project to amend lease modification accounting under Topic 842 for certain reductions within the scope of lease contracts. The amendments would exempt entities (both lessees and lessors) from applying modification accounting to the remaining lease components within a lease contract for transactions in which termination of one or more lease component(s) does not economically affect the remaining lease component(s) in that contract.

Applicable Accounting Guidance

3. Under Topic 840, a modification (other than a renewal or a lease term extension) does not create a new lease if the existence of modified terms at lease inception would not have resulted in a change in classification.

> **840-10-35-4** If at any time the lessee and lessor agree to *change the provisions of the lease*, other than by renewing the lease or extending its term**,** *in a manner that would have resulted in a different classification* of the lease under the lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 *had the changed terms been in effect at lease inception,* the revised agreement shall be considered as a new agreement over its term, and the lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 shall be applied for purposes of classifying the new lease.

> Likewise, except if a guarantee or penalty is rendered inoperative as described in paragraphs 840-30-35-8 and 840-30-35-23, any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the guidance in Section 840-10-25. *Changes in estimates* (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee) *shall not give rise to a new classification* of a lease for accounting purposes.
>
> [Emphasis added.]

4. Under Topic 842, any contract modification that does not create a separate contract (see paragraph 842-10-25-8 below) will result in the existing lease being treated as a new lease. This requires an entity to reassess lease classification and to remeasure the existing lease as of the effective date of the modification.

> **842-10-25-8** An entity shall account for a modification to a **contract** as a *separate contract* (that is, separate from the original contract) when both of the following conditions are present:
>
> a. The modification grants the **lessee** an additional right of use not included in the original **lease** (for example, the right to use an additional asset).
>
> b. The **lease payments** increase commensurate with the **standalone price** for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a **lessor** to incur costs that it would have incurred for a new lessee.
>
> **842-10-25-9** If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall *reassess the classification of the lease* in accordance with paragraph 842-10-25-1 as of the ***effective date of the modification*.**
>
> **842-10-25-1** An entity shall classify each separate lease component at the commencement date. An entity shall not *reassess the lease **classification*** after the commencement date *unless the contract is modified and the modification is not accounted for as a separate contract* in accordance with paragraph 842-10-25-8. In addition, *a lessee also shall reassess the lease classification* after the commencement date *if there is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset*. When an entity (that is, a lessee or lessor) is required to *reassess lease classification*, the entity shall reassess classification of the lease *on the basis of the facts and circumstances* (and the modified terms and conditions, if applicable) *as of the date the reassessment* is required (for example, on the basis of

the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset or as of the effective date of a modification not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

[Emphasis added.]

5. The following paragraphs in Topic 842 require that an entity remeasure and reallocate the remaining consideration in the contract for a lease modification that is not accounted for as a separate contract:

> > Lessor

842-10-15-41 A *lessor* shall *remeasure and reallocate the remaining consideration in the contract* when there is a contract modification that is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

> > Lessee

842-10-25-11 A **lessee** shall reallocate the *remaining **consideration in the contract*** and remeasure the **lease liability** using a **discount rate for the lease** determined at the **effective date of the modification** if a contract modification does any of the following:

a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8)
b. Extends or reduces the term of an existing **lease** (for example, changes the **lease term** from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5)
c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)
d. Changes the consideration in the contract only.

[Emphasis added.]

6. The basis for conclusions of Accounting Standard Update No. 2016-02, *Leases (Topic 842),* provides the following about the Board's decision to require certain modifications to be treated as new leases as opposed to separate contracts:

BC170. The Board decided that some modifications to existing contracts that are leases or contain leases should not affect the accounting for a lease in the original contract. The Board decided that if a modification grants the lessee additional rights of use (for example, the right to use an additional asset) and the lease payments increase commensurate with the standalone price for those additional rights, that lease should be accounted for as a separate contract (that is, separate from the original contract).

BC171. In those circumstances, the Board decided that *accounting for the modification (or amendment) separate from the original contract is appropriate because the new lease does not affect the original contract. It does not change the scope or the consideration allocable to the lease and nonlease components in the original contract. The Board also concluded that accounting for modifications of this nature as separate contracts reduces complexity* because it does not require an entity to adjust its established accounting for the original contract.

BC172. In contrast, *a modification that does not meet the criteria to be accounted for as a separate contract changes the terms and conditions of the existing lease(s) between the parties*. This includes a modification that grants the lessee additional rights of use but the increase in the lease payments is not commensurate with the standalone price for those additional rights. In that case, the modification changes the terms and conditions of the existing lease by changing the lease payments (after reallocation of the consideration in the contract).

BC173. When a modification does not meet the criteria to be accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the effective date of the modification as if the modified lease were a new lease that commences on that date. *Because the Board decided that a modified lease is accounted for as if it were a new lease at the effective date of the modification, the lessee reassesses the classification of the lease and remeasures the right-of-use asset and the lease liability based on the changed terms and conditions of the modified contract (including the changed lease payments).*

[Emphasis added.]

7. The following paragraph in the basis for conclusions of Update 2016-02 summarizes lessor accounting for lease modifications:

BC178. In Topic 842, a modification is accounted for prospectively by a lessor from the effective date of the modification (that is, no profit or loss is recognized) unless the modification, in effect, results in the sale of the underlying asset by transferring control of the asset to the lessee. This occurs when an operating lease or direct financing lease is modified, and the modified lease is classified as a sales type lease. Topic 842 provides guidance, including illustrative examples, on how to effect the prospective accounting (for example, specifying the effect of any prepaid or accrued rentals on the accounting for the modified lease and how to calculate the post modification net investment in the lease for sales-type and direct financing leases). This includes guidance for scenarios in which the lease classification changes as a result of the modification (for example, from operating lease to sales-type lease or from direct financing lease to operating lease). The Board decided to provide relatively detailed guidance and examples to ensure the guidance is understandable and can be applied in a consistent manner.

8. The following paragraphs in Topic 842 require lessors to account for lease modifications prospectively unless the modification results in a sale of the underlying asset:

> > Lessor

842-10-25-15 If an **operating lease** is modified and the modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8, the **lessor** shall account for the modification *as if it were a termination of the existing **lease** and the creation of a new lease* that commences on the **effective date of the modification** as follows:

a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the **lease payments** for the modified lease.

b. If the modified lease is classified as a **direct financing** lease or a **sales-type lease**, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or selling loss accordingly.

842-10-25-16 If a direct financing lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a direct financing lease, the lessor shall *adjust the discount rate for the modified lease* so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the **commencement date** of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the **fair value** of the **underlying asset** is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

842-10-25-17 If a sales-type lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)

b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).

[Emphasis added.]

9. The following paragraphs in the basis for conclusions of Update 2016-02 describe the Board's decision to align the lease modification guidance in Topic 842 to the contract modification guidance in Topic 606, Revenue from Contracts with Customers:

> BC179. The Board decided that having a model for lease modifications that is generally consistent with that for contract modifications both (a) is appropriate on a conceptual basis given that leasing is fundamentally a revenue-generating activity for lessors and (b) will reduce complexity for lessors that regularly provide nonlease goods or services to their customers in conjunction with their leasing activities.
>
> BC180. . . because the Board decided that it is more important to align the modifications guidance to that in Topic 606, particularly for lessors that regularly provide nonlease goods or services. The Board's decision to align the lease modifications guidance with the contract modifications guidance in Topic 606 is conceptually consistent with the Board's decisions elsewhere in Topic 842 to align the lessor accounting guidance with the revenue recognition guidance where it is reasonable to do so.

10. The contract modification guidance in Topic 606 provides the following:

> **606-10-25-12** An entity shall account for a contract modification as a *separate contract* if both of the following conditions are present:
>
> a. The scope of the contract increases because of the *addition of promised goods or services that are distinct*. . .
>
> b. The price of the contract increases by an amount of consideration that reflects the entity's **standalone selling prices** of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract…
>
> **606-10-25-13** If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:
>
> a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the *creation of a new contract*, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification.
>
> [Emphasis added.]

11. Topic 840 provides the following lessee-specific guidance regarding modifications that involve a termination penalty. Topic 842 does not include similar guidance but, rather, provides general guidance on remeasurement of remaining consideration in the contract in performing modification accounting (see paragraph 842-10-25-11 for lessee and paragraph 842-10-15-41 for lessor).

> > Determining Whether a Lease Modification Involves a Termination Penalty

840-20-55-4 This guidance addresses how, in the circumstances described, the adjustment to the lease term and the increase in the lease payments over the shortened lease period should be accounted for by the lessee. An entity leases an asset under an operating lease for use in its operations. Before the expiration of the original lease term, the lessee and lessor agree to modify the lease by shortening the lease term and increasing the lease payments over the shortened lease period. The modifications do not change the lease classification and no other changes are made to the lease.

840-20-55-5 The treatment by the lessee of the increase in the lease payments over the shortened lease period is a matter of judgment that depends on the relevant facts and circumstances**.** *If the increase is, in substance, only a modification of future lease payments, the increase should be accounted for by the lessee prospectively over the term of the modified lease* as discussed in paragraph 840-20-25-1. *If the increase is, in substance, a termination* ***penalty****, it should be charged by the lessee to income of the period of the modification* as discussed in by paragraphs 420-10-30-8 through 30-9. Factors to consider in determining the nature of the increase include both of the following:

a. The term of the modified lease as compared with the remaining term of the original lease. The shorter the term of the modified lease is in comparison to the remaining term of the original lease, the more likely it is that the increase in the lease payments represents a termination penalty.

b. The relationship of the modified lease payments to comparable market rents. The closer the modified lease payments are to comparable market rents, the more likely it is that the increase in the lease payments represents a modification of future lease payments.

840-20-55-6 If the increase in the lease payments represents a termination penalty, the amount of the charge should be calculated by the lessee as the excess of the modified lease payments over the lease payments that would have been required over the shortened period under the original lease. The amount to be recognized by the lessee may be based on either undiscounted or discounted amounts provided that the accounting policy is consistently applied and disclosed in accordance with Topic 235.

[Emphasis added.]

Summary of Outreach

12. This section includes feedback received on modification accounting from the large accounting firms in June 2020 as a part of the Board's ongoing post-implementation activities. This section also includes feedback received on this issue during outreach activities in 2019 from a large preparer group.

Large Accounting Firms

13. All large firms asserted that the general framework for modification accounting in Topic 842 is an improvement over Topic 840. Those firms emphasized that the underlying principles of the Topic 842 modification model are appropriate given that the Board wanted modifications that do not create separate contracts to be accounted for consistent with the accounting for new leases. Many added that a reassessment of lease classification based on updated assumptions related to the underlying asset and discount rate is conceptually appropriate given the Board's objective of accounting for modifications as new leases. Some firms noted that the benefits of reflecting the "modified" or "new" underlying economics outweigh administrative burdens. Some firms also expressed that the consistency of modification accounting in Topic 842 with that in Topic 606 is important because leasing is a revenue-generating activity for lessors.

14. Many firms cautioned against broad changes to the Topic 842 modification model for both practical and conceptual reasons. They highlighted that all public business entities have adopted Topic 842 and that new systems and processes established to comply with Topic 842 would be severely affected if changes were made. They also were concerned that any further divergence from IFRS 16 could add costs for dual reporting entities. Some of the firms commented that operational issues with modification accounting as a result of the COVID-19 pandemic were present under the guidance in both Topic 840 and Topic 842, and that a global pandemic should not trigger changes to the lease modification model because it is a unique event that has resulted in high volume of modifications in a short period of time.

15. One firm that does not support broad changes to the Topic 842 lease modification model emphasized that if a modification creates a "new" lease, then the accounting requirements for that modified lease should be the same as those for a new lease at the commencement date. That firm noted that, conceptually, the accounting for an economic effect achieved through an amendment to an existing lease or the execution of a new lease should be the same. That firm added that if the principles related to lease modification are changed in a manner that it is not aligned with the accounting at

lease commencement, then similar consideration should be given to the initial accounting requirements for new leases.

16. In discussing whether a reclassification (with updated assumptions) should be required, for example, when the term or scope of an operating lease is reduced, most of the firms stated that relief could be provided from reconsidering classification. However, none supported leveraging the principles in Topic 840 that provide that except for lease renewals or lease term extensions, reassessment of classification is performed only when a modification is made in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at lease inception. Additionally, most rejected the concept of not updating assumptions (lessee discount rate, fair value, etc.) when reassessing classification at the modification date for certain types of modifications, which is another aspect of the legacy modification guidance in Topic 840. Some firms who support the underlying principles of the Topic 842 modification model noted their preference to retain a requirement for an entity to update its assumptions for all modifications, including reductions within the scope or lease term.

17. In discussing lessee-specific issues, all firms agreed that updating the incremental borrowing rate (IBR) at the modification date can be challenging. One firm asserted that updating IBR will become easier with the development of systems and processes. Most of the firms expressed that updating other assumptions (useful life or fair value of asset) to reassess classification is generally not as complex as updating IBR.

18. Most firms agreed that the issue currently being considered by the Board and discussed above in the Issue Background section about certain reductions within the scope of a lease contract could be an improvement for both lessees and lessors.

19. In discussing general areas of improvements, some of the firms noted that relief could be provided for “minor” modifications that do not significantly affect the economics of the original lease. Those firms observed that, for such modifications, the costs and complexity of applying lease modification guidance in Topic 842 may outweigh the benefits of the resulting accounting (because the change is minor) and may not improve the decision usefulness of information provided.

20. A couple of firms highlighted that Topic 842 requires prospective, rather than point-in-time, accounting for modifications that include termination penalties. Those firms observed that prospective accounting may not always appropriately reflect the economics of certain modifications (for example, when a lease is modified to reduce the lease term and the lessee is required to pay a termination penalty/fee). In contrast, Topic 840 includes guidance for entities to determine the accounting treatment based on whether the increase in payment was, in substance, a termination

penalty (point-in-time accounting) or a modification of future lease payments (prospective accounting). Those firms suggested that the Board consider revising the guidance for termination penalties payable upon modifications. For lessors, all firms noted that the accounting for a termination penalty in Topic 842 is aligned with the contract modification guidance in Topic 606 and that a change to Topic 842 would break the alignment with Topic 606, which may make the guidance more complex for lessors. All firms agreed that economic analysis of termination penalties could be very complex, which is why most firms did not support changes to the existing requirement in Topic 842.

Preparer Group

21. The large preparer group asserted that the lease modification guidance in Topic 842 is complex. That group also provided specific implementation issues that they have encountered when applying the Topic 842 modification accounting requirements.

22. The preparer group highlighted an issue where a lessor's lease classification may change upon a modification solely because of the passage of time. For example, a minor change to a sales-type or direct financing lease could result in a lessor reclassifying that lease as an operating lease (even though the lease term was not modified and no significant changes to the economics of the lease were made). The group did not think that this outcome was appropriate.

23. The preparer group highlighted that when a lessor reclassifies a sales-type or direct financing lease to an operating lease solely because of the passage of time, the application of the Topic 842 modification guidance results in a balance sheet reclassification (net investment in lease to equipment). To avoid operating lease classification, finance lessors often will purchase additional residual value insurance to maintain direct financing lease classification, resulting in additional costs (cash outflow) solely because of a change in lease accounting guidance. This issue does not arise under Topic 840 because that Topic requires that entities reclassify a lease only when a modification (that is not a renewal or term extension) is made in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at lease inception. Certain firms commenting on this issue noted that they find that it exists in sale-leaseback transactions (currently being considered by the staff as part of an agenda request) and in certain reductions within the scope of master lease agreements (currently being addressed by the Board).

Staff Observations

24. The staff observes that the lease modification guidance in Topic 842 is significantly different from the guidance in Topic 840. Furthermore, the staff observes that the lease modification guidance in Topic

842 is based on the underlying principle that modifications that do not create separate contracts are new leases and are accounted for consistent with the accounting for all new leases.

25. On the basis of feedback received from large accounting firms and a large preparer group, the following issues (discussed in the Summary of Outreach section) were raised related to modification accounting in Topic 842:

    (a) Certain reductions within the scope of a lease contract (for example, a master lease agreement) (currently being considered by the Board)

    (b) Reassessment of lease classification upon a modification that does not create a separate contract (for example, reductions in lease term), including updating assumptions (for example, lessee discount rate and economic life and fair value of the underlying asset)

    (c) Accounting for termination penalties

    (d) Minor modifications.

26. The staff is seeking feedback on the specific issues noted above, as well as broad feedback on the lease modification model in Topic 842 (including the recent staff Q&A) and whether certain aspects of that guidance may be improved without compromising the decision usefulness of the information.

Questions for Discussion
1. What are your views on the recent decisions made by the Board to propose amendments to the guidance applicable to certain reductions within the scope of a lease contract? 2. What are your views on the issues discussed in this memo? 3. What other aspects of lease modification accounting in Topic 842 may be improved without compromising the decision usefulness of the information?

TOPIC 5: Lessee Allocation of Fixed and Variable Payments

Issue Background

1. This issue relates to the lessee's allocation guidance in Topic 842, Leases. Under Topic 842, a lessee is required to identify the separate lease and nonlease components of a contract and allocate the consideration in the contract to those separate components. The staff has received feedback from stakeholders that in some situations the application of that guidance by the lessee may yield allocation results that do not reflect the economics of lease transactions. This may occur when the lease contract includes (a) lease and nonlease components along with (b) fixed and variable payments. Stakeholders also indicated that the allocation requirements are operationally challenging to apply, which can create added cost and complexity in accounting for leases under Topic 842.

2. Consideration in the contract generally comprises all required fixed payments (and variable payments that depend on an index or rate, initially measured at the index or rate as of the lease commencement date). Hereinafter, we will refer to consideration in the contract as fixed payments for simplicity purposes. All other variable payments (hereinafter referred to as variable payments) are omitted from the consideration in the contract and recognized as lease expense in the period that the obligation to make the lease payment is satisfied.

Allocation of Payments

3. A lessee must determine the standalone selling prices of the lease and nonlease components and allocate the total fixed payments to those components on a relative standalone selling price basis. For example, assume the total fixed payments are $100,000 and the standalone prices of the lease component and nonlease component are $100,000 and $10,000, respectively. To simplify the example, rounding should be ignored and assume that the lessee would allocate 91 percent ($100,000/$110,000) or $91,000 to the lease component and 9 percent ($10,000/$110,000) or $9,000 to the nonlease component.

4. A lessee is required to allocate variable payments to the lease and nonlease components in the period that the obligation to make those payments is incurred. That allocation is required on the same basis as the initial allocation of the consideration in the contract (that is, 91 percent to the lease and 9 percent to the nonlease component).

5. The allocation of total fixed payments and variable payments occurs in that manner regardless of what the contract terms stipulate (what component has a fixed payment and what component has variable

payment). That is, the standalone selling prices support the amount of the allocation; the timing of when the allocation occurs depends on whether the payments are fixed or variable.

6. For example, assume that the contract stipulates that the total fixed payments in the contract are $10,000 per year for 10 years or $100,000 and that those payments relate solely to the lease component. The fixed payments are considered commensurate with market prices. The contract also stipulates that maintenance services will be provided on that asset (the nonlease component) and will be billed annually at a market-based rate (variable payments). Regardless of what is stipulated, the lessee would have to (a) determine standalone prices for the lease component and the nonlease component and (b) allocate a portion of both the fixed payments and the variable payments (when incurred) to the lease and nonlease components on a relative standalone basis under Topic 842. Because the lease component is commensurate with market prices, its standalone selling price is $100,000. Assume that the lessee estimates that the standalone selling price of the service component (nonlease component) is $10,000. Assume the lease is an operating lease.

   (a) For the fixed payments, $91,000 would be used as the basis for the lease liability (before discounting) and $9,100 of lease cost would be recognized annually on a straight-line basis for 10 years. Assuming that the lessee recognizes the maintenance services on a straight-line basis throughout the lease term, it will recognize $900 of maintenance expense per year.

   (b) For the variable payments, assume that lessee incurs the obligation to make variable maintenance payments at the end of each year. At the end of Year 1, $1,000 of maintenance services are charged by the lessor to the lessee. The lessee will allocate 91 percent or $910 to lease cost and 9 percent or $90 to maintenance expense.

   So, in total for Year 1, the lessee would allocate $10,010 to lease cost and $990 to maintenance expense.

7. To alleviate operational burdens associated with the lessee allocation guidance, the Board allowed lessees to elect, by class of underlying asset, to combine lease and nonlease components and account for them as a single lease component. A lessee electing this expedient treats all payments, fixed and variable, as lease payments. This results in the fixed payments in a contract being solely attributed to the lease component, naturally resulting in a larger lease liability than if the components were separated and a portion of the fixed payments were allocated to the nonlease component. A lessee electing this expedient also would account for variable payments as lease expense in their entirety in the period that the obligation to make the lease payment is satisfied.

8. If the lessee in the previous example elects the practical expedient to combine lease and nonlease components, the lessee would use the $100,000 of fixed payments as the basis of its lease liability and recognize the fixed payments on a straight-line basis, resulting in $10,000 of lease cost each year. The lessee also would recognize the variable payment of $1,000 as lease cost when it is incurred at the end of Year 1. Therefore, in total for Year 1, the lessee would recognize $11,000 of lease cost using the practical expedient.

9. If the lessee was able (which it is not under Topic 842) to recognize fixed and variable payments in accordance with the terms of the contract and the lessee could demonstrate that the payments in the contract represent standalone selling prices,, the lessee would use $100,000 as the basis for its lease liability. It would recognize fixed payments on a straight-line basis of $10,000 per year for 10 years as lease expense. When the variable payments for maintenance services of $1,000 are incurred n Year 1, the lessee would recognize it as maintenance expense. Therefore, in total for Year 1, the lessee would recognize $10,000 of lease cost and $1,000 of maintenance expense.

10. In this example, all of the fixed payments in the contract relate to the lease component. Therefore, the lease liability is the same ($100,000) whether the lessee recognizes fixed and variable payments following contract terms as discussed in the previous paragraph or uses the combination practical expedient. If a contract includes fixed payments that relate to a nonlease component, the outcome would be different. In that case, if the lessee elects to combine the lease and nonlease component, the entire fixed payment would be used to measure the lease liability, resulting in a higher liability. In contrast, if the lessee was able to recognize payments following the contract terms (which is not allowed under Topic 842), only the portion of the fixed payments stipulated to relate to the lease component would be used to measure the liability, resulting in a lower liability. This difference would be particularly amplified in situations in which the nonlease component is large relative to the lease component, which may cause the amount recognized for the lease liability under the combination practical expedient to not reflect the economics of the transaction as well.

11. This example shows that the amounts recognized under the Topic 842 lessee allocation guidance, the lessee practical expedient, and those that would be recognized per stipulated contract terms (assuming that the amounts represent standalone selling prices) will probably differ and the difference could be material in certain situations. Although the total amount reported on the income statement in any period would be the same, the income statement classification and the amount of the fixed payments used to determine the lessee's lease liability will differ.

12. In contrast, the lessor allocation guidance in Topic 842 is fundamentally aligned with the transaction price allocation guidance in Topic 606, Revenue from Contracts with Customers. The guidance in Example 35, Case A, in the Topic 606 implementation guidance illustrates the allocation of amounts in accordance with contractually stipulated terms if the allocation objective in Topic 606 supports that allocation. As a result, lessors do not have the issue described above. Lessees do not follow the Topic 606 allocation guidance.

13. Along with potentially yielding allocation results that do not reflect the economics of lease transactions with lease and nonlease components along with fixed and variable payments, allocating lease and nonlease components in those situations can cause operational issues. This is because payments for nonlease components may not be tracked within a lease system. Rather, they may be processed within a lessee's procurement system and the requirement to split those payments between multiple general ledger accounts or cost centers may be counterintuitive and often is manual.

Applicable Accounting Guidance

14. Paragraphs 842-10-15-33 through 15-44 provide guidance on how the consideration in the contract should be allocated between lease and nonlease components:

> **842-10-15-33** A **lessee** shall allocate (that is, unless the lessee makes the accounting policy election described in paragraph 842-10-15-37) the **consideration in the contract** to the separate **lease** components determined in accordance with paragraphs 842-10-15-28 through 15-31 and the nonlease components as follows:
>
> a. The lessee shall determine the relative **standalone price** of the separate lease components and the nonlease components on the basis of their observable standalone prices. If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.
>
> b. *The lessee shall allocate the consideration in the contract on a relative standalone price basis to the separate lease components and the nonlease components of the **contract**.* [Emphasis added.]
>
> **Initial direct costs** should be allocated to the separate lease components on the same basis as the **lease payments**.
>
> **842-10-15-34** A price is observable if it is the price that either the **lessor** or similar suppliers sell similar lease or nonlease components on a standalone basis.

15. Guidance on what constitutes consideration in the contract (referred to as fixed payments in this memo) is within paragraphs 842-10-15-35 and 842-10-30-5, follows:

> **842-10-15-35** The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the lease term:
>
> a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5
>
> b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.
>
> **842-10-30-5** At the **commencement date**, the **lease payments** shall consist of the following payments relating to the use of the **underlying asset** during the **lease term**:
>
> a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the **lessee** (see paragraphs 842-10-55-30 through 55-31).
>
> b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
>
> c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
>
> d. Payments for **penalties** for terminating the **lease** if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
>
> e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the **fair value** of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
>
> f. For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).

16. Paragraph BC156 of Accounting Standards Update No. 2016-02, *Leases (Topic 842),* provides the Board's reasoning for not aligning lessee allocation guidance to the Topic 606 allocation guidance, acknowledging that lessor allocation is indeed aligned with Topic 606:

> *The allocation guidance for lessees in Topic 842 does not reference other Topics; the Board decided that it will be less complex and more intuitive for lessees to include the allocation guidance within the leases Topic. The Board also decided that having lessees apply the revenue recognition guidance in Topic 606 (as is the case for lessors) does not make conceptual sense because a lessee is the customer in a lease rather than the supplier. However, the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP, although some additional rigor has been added to the process for determining the standalone price of a lease or nonlease component.* That is, the Board decided that in determining the

standalone price of lease and nonlease components of the contract, a lessee is required to use observable standalone prices, if available, before using an estimated standalone price. Furthermore, a lessee should maximize the use of observable inputs and apply estimation methods consistently in similar circumstances when estimating a standalone price. The Board decided that the ability to estimate standalone prices should include the ability to use a residual approach to estimate the standalone price, subject to the requirement to maximize the use of observable inputs in estimating the standalone price. [Emphasis added.]

17. Unlike for lessors for which guidance on allocation is within the scope section of Subtopic 842-10 (see paragraphs 842-10-15-39 through 15-40 below), guidance on how lessees allocate variable payments exists solely in the implementation guidance. Specifically, Example 14 provides the following:

> > > Example 14—Determining the Consideration in the Contract—Variable Payments

> > > > Case A—Variable Payments That Relate to the Lease Component and the Nonlease Component

842-10-55-150 Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (that is, the equipment is not malfunctioning or inoperable). *The potential $7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity.* The lease is an operating lease.

842-10-55-151 *In accordance with paragraph 842-10-15-35, variable payments other than those that depend on an index or a rate are not accounted for as consideration in the contract by Lessee.* Therefore, the consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of $100,000 each year (or $300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are $285,000 and $45,000, respectively.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 259,091
Maintenance	45,000	40,909
	$ 330,000	$ 300,000

Each $100,000 annual fixed payment and *each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance services).* Therefore, annual lease expense, excluding variable expense, is $86,364. Lessee recognizes the expense related to the variable payments in accordance with paragraphs 842-20-25-6 and 842-20-55-1 through 55-2.

[Paragraph 842-10-55-152 relates to lessor accounting and, therefore, is not included with these quotes.]

> > > > Case B—Variable Payments That Relate Specifically to a Nonlease Component

842-10-55-153 Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-150 through 55-152), except in this scenario the maintenance services are highly specialized, and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

842-10-55-154 *Lessee would account for the potential variable payments consistent with Case A. The rationale for this accounting also is consistent with that in Case A.*

842-10-55-155 In contrast to Case A, Lessor concludes that *the variable payments relate specifically to an outcome from Lessor's performance of its maintenance services.* Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13.

[Emphasis added.]

18. To alleviate operational burdens of separating and allocating consideration in the contract and variable payments, the Board provided lessees with the following practical expedient:

842-10-15-37 As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to 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 lease component.

19. Paragraph 842-10-15-38 provides guidance on how lessors allocate the consideration in the contract to lease and nonlease components, as follows:

842-10-15-38 *A **lessor** shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) the **consideration in the contract** to the separate **lease** components and the nonlease components using the requirements in paragraphs 606-10-32-28 through 32-41.* A lessor also shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) any capitalized costs (for example, **initial direct costs** or **contract** costs capitalized in accordance with Subtopic 340-40 on other assets and deferred costs—contracts with customers)

> to the separate lease components or nonlease components to which those costs relate. [Emphasis added.]

20. Paragraphs 842-10-15-39 through 15-40 provide allocation guidance for variable payments for lessors whereby, in certain circumstances, the entire variable payment can be allocated to a single component (lease or nonlease), as follows:

> **842-10-15-39** The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:
>
> a. The lessor's efforts to transfer one or more goods or services that are not leases
>
> b. An outcome from transferring one or more goods or services that are not leases.
>
> *Any variable payment amounts accounted for as consideration in the contract shall be allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.*
>
> **842-10-15-40** If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall not recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the **lessee's** sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract *unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s).* Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).
>
> [Emphasis added.]

21. The allocation objective in Topic 606 (paragraph 606-10-32-28) is ". . .for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer."

22. Moreover, paragraph 606-10-32-40 provides guidance on when a variable payment should be allocated entirely to a single performance obligation (analogous to a component) and states:

> **606-10-32-40** An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:
>
> a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
>
> b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

23. Finally, Example 35, Case A in the Topic 606 implementation guidance (paragraphs 606-10-55-270 through 55-274) illustrates a scenario in which a contract has two performance obligations (X and Y). The contractual price for X is fixed and the variable for Y. On the basis of the allocation objective in Topic 606 and the variable payment guidance in paragraph 606-10-32-40, the example concludes that the total fixed payment should be allocated entirely to X and the variable payment entirely to Y.

Summary of Outreach

24. This issue was raised by a large accounting firm and a practitioner member of the AICPA's Technical Issues Committee. Those stakeholders are concerned that the lessee allocation guidance may not produce financial reporting that represents the economics of a contract with both fixed and variable payments. They also noted the operational challenges mentioned in the Issue Background section.

25. They expressed concern that, notwithstanding the lessee allocation guidance, some lessees may be recognizing lease and nonlease components solely in accordance with stipulated terms of a contract, primarily because it is intuitive to those lessees to do so (resulting in noncompliance with Topic 842). Additionally, it was asserted that many lessees elect the practical expedient to combine components and account for the combined component as a lease component to avoid what they consider to be an arduous allocation process. Studies done by the large accounting firms and a prominent accounting consulting firm highlight that a significant majority of public business entity (PBE) lessees have elected that expedient.

Potential Alternatives

26. The following are potential preliminary alternatives for this issue:

    (a) Alternative A – Amend lessee allocation guidance

    (b) Alternative B – No changes to Topic 842.

Staff Observations

Alternative A – Amend Lessee Allocation Guidance

27. This alternative would amend the lessee allocation guidance to require the allocation of fixed and variable payments solely to a lease or nonlease component if certain conditions exists. For example, this could be the case if the contractual payments (a) relate solely to the lessor's obligation to provide, or lessee's right to receive, the right to use the underlying asset (lease component) or a service (nonlease component) and (b) represent the standalone selling price of that component. This alternative would seem to provide financial reporting that represents the economics of an arrangement with those conditions. Additionally, there is precedent for this alternative as allocating solely to a component (or performance obligation) is required for lessors and in Topic 606 if conditions support that allocation.

28. This alternative would require standard setting. More outreach and research would be needed to develop guidance that is operable and results in decision-useful information. This alternative would probably require consideration of the allocation guidance in Topic 606 to develop the appropriate language for determining when to allocate fixed or variable payments to a single component in contracts where both lease and nonlease components exist. It is important to note that in developing the existing lessee allocation guidance, the Board decided that having lessees apply the allocation guidance in Topic 606 (as is the case for lessors) did not make conceptual sense because a lessee is the customer in a lease rather than the supplier. However, since the implementation of Topic 606 in 2018, practice has evolved to comprehend and apply the allocation principles for revenue arrangements in Topic 606, and, as such, expansion of those principles to Topic 842 for lessee allocation may not create new areas of costs or complexity.

29. Separately, consideration must be given to the fact that all PBEs have adopted Topic 842 and have either applied the lessee allocation guidance or elected the practical expedient to combine components and account for those components as a single lease component. Thus, if amendments are made to the allocation guidance, transition would be critical.

Alternative B – No Change to Topic 842

30. All PBEs have adopted Topic 842. Amending the lessee allocation guidance would be a significant change, particularly for lessees who are allocating fixed and variable payments in accordance with Topic 842. Lessees that want to avoid the allocation requirements can elect to combine lease and nonlease components and account for the entire component under Topic 842. Given that a significant

majority of lessees are electing the expedient, the staff does not know if this issue is pervasive enough to warrant such a significant change.

Questions for Discussion
1. What are your views on the issue discussed in this memo?
2. Are there any other alternatives to address the issue?
3. What alternative do you support and why?