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FASB Proposes Targeted Improvements to Leasing Guidance

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On October 20, 2020, the FASB issued for public comment an exposure draft (ED) of a proposed ASU[1] that addresses the following issues stakeholders have raised regarding the implementation of ASC 842:[2]

- Sales-type leases with variable lease payments — lessor only (Issue 1).
- Option to remeasure lease liability — lessee only (Issue 2).
- Modifications reducing the scope of a lease contract (Issue 3).

This *Heads Up* summarizes the ED's proposed amendments related to these issues. In addition, the appendix reprints the ED's questions for respondents. Comments on the proposed ASU are due by December 4, 2020.

As always, we encourage stakeholders to participate in the standard-setting process and provide their feedback to the FASB. Moreover, as discussed in our *Heads Up* summarizing the FASB's public roundtable held on September 18, 2020, the Board continues to review stakeholder feedback and may consider making additional potential improvements to ASC 842.

Item 1: Sales-Type Leases With Variable Lease Payments — Lessor Only

ASC 842 requires that lessors exclude variable lease payments that do not depend on an index or rate (hereafter referred to as "variable payments") from measurement of the "net investment in the lease" asset. Accordingly, for sales-type leases in which a significant portion of the payments is expected to be variable payments, the recognition of the net investment in

[1] FASB Proposed Accounting Standards Update (ASU), *Leases (Topic 842): Targeted Improvements*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

the lease may be less than the derecognition of the underlying asset. The lessor therefore may recognize a day 1 loss for accounting purposes even when the economics of the arrangement are expected to be profitable. The subsequent variable payments would be recognized in their entirety as lease revenue instead of being allocated between a reduction of the net investment in the lease and interest income.

Some stakeholders are concerned that the current accounting requirements for these arrangements do not result in reporting that faithfully represents the economics of the transaction, both at lease commencement (i.e., day 1 loss) and over the lease term (i.e., higher lease income). Such stakeholders therefore question whether financial statement users are being provided with the most relevant and useful information.

In the ED, the Board recommends that leases with predominantly variable payments be classified as operating leases. In such circumstances, the lessor would not derecognize the underlying asset upon lease commencement but would continue to depreciate the underlying asset over its useful life. Further, in accordance with ASC 842-30-25-11, the lessor would recognize fixed lease payments as "income . . . over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset." Variable lease payments would be recognized as "income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur."

In assessing whether the lease payments are predominantly variable payments, the lessor should consider "predominance" in the same manner as it does when determining the predominant component of a combined lease and nonlease component under the revenue or leasing guidance (see ASC 842-10-15-42B). Further, paragraph BC12 of the ED clarifies that the term "predominant" is expected to mean "majority." Accordingly, if the variable payments are expected to be greater than the fixed lease payments, the lessor would account for the arrangement as an operating lease as described herein. The FASB acknowledged that entities that perform this assessment may need to estimate variable payments.

Connecting the Dots

The ED's proposed amendment to require classification of leases with predominantly variable payments as operating leases would increase alignment of IFRS Standards® and U.S. GAAP. Under IFRS 16,[3] a lease is classified as an operating lease "if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset." The standard goes on to suggest that variable lease payments could preclude the lessor from transferring substantially all the risks and rewards of ownership.[4] IFRS 16 does not specifically define what level of variable payments would prevent the transfer of risks and rewards of ownership, while lessors applying the guidance in the ED would use the "predominant" threshold described above to assess whether they should classify a lease as operating.

Item 2: Option to Remeasure Lease Liability — Lessee Only

IFRS 16 differs from ASC 842 regarding the requirements for remeasuring lease liabilities and the associated right-of-use assets when future lease payments are based on a reference index or rate. ASC 842 currently requires a lessee to measure its lease liability by using the variable payments based on an index or rate that are effective as of the commencement date. When lease payments change in accordance with the reference index or rate, the lessee is *precluded* by ASC 842 from remeasuring the lease liability for the subsequent changes in lease payments. In contrast, IFRS 16 *requires* a lessee to remeasure the lease liability when there are subsequent changes in the lease payments in accordance with changes in the reference index or rate.

[3] IFRS 16, *Leases*.
[4] See paragraphs 62 and 65 of IFRS 16.

This divergence of U.S. GAAP from IFRS Standards has created ongoing costs and complexities for preparers that report under both sets of standards. Those costs and complexities include system difficulties resulting from maintenance of different payment schedules for leases with payments based on a reference index or rate.

Accordingly, the ED would amend the guidance in U.S. GAAP so that lessees could elect to remeasure lease liabilities for changes on the basis of a reference index or rate affecting future lease payments. This proposed amendment would be consistent with IFRS 16; however, such remeasurement is required under IFRS 16 and not merely optional.

Connecting the Dots

This amendment, which allows entities to elect to remeasure lease liabilities for changes in lease payments on the basis of an underlying index or rate, results in greater convergence with IFRS 16, under which entities are required to remeasure for such changes in lease payments.[5]

Item 3: Modifications Reducing the Scope of a Lease Contract

In a lease agreement, the lessor may provide the lessee with the right to use multiple assets through the lease term. For example, a lessee might enter into a master lease agreement to obtain the right to use 100 trucks. The scope in a master lease agreement would be reduced if the lessee determines that only 90 trucks will be necessary and modifies the contract with the lessor to reduce the number of assets. Under current GAAP, this reduction would be considered a lease modification and both the lessor and the lessee would therefore be required to (1) reconsider classification of the ongoing 90 lease components and (2) remeasure all of the remaining lease components under the arrangement. This requirement would apply even if the remaining lease components are not economically affected by the modification. Accordingly, the entity would be required to account for the amended agreement as a new lease as of the modification date, potentially resulting in changes to classification and measurement of the remaining lease components. For example, the lessor that classified the 100 leases as sales-type leases at lease commencement may, as of the date of the modification, reassess classification of the 90 remaining leases and determine that they are operating leases solely because of the impact that the passage of time has had on the lease classification indicators.

Certain stakeholders have asserted that this requirement creates unnecessary cost and complexity for financial statement preparers who are required to apply the entire lease modification framework when the scope of a lease agreement has changed but the remaining lease components are not economically affected.

The ED would exempt an entity from applying modification accounting to the remaining lease components in a lease contract for transactions in which one or more lease components are terminated before the end of the lease term and that early termination does not economically affect the remaining lease components. Paragraph BC26 of the ED emphasizes that in evaluating how total payments associated with the remaining lease components have changed, it is critical for an entity to determine whether those remaining components are economically unaffected in such a way that this exemption to the modification framework applies. This evaluation should take into account contractual payments over the remaining lease term as well as any termination payments required in the partial termination.

The change proposed by the ED extends beyond master lease agreements and could apply to any lease arrangement with multiple components, regardless of whether those components were separately identified at commencement. For example, a lessee may enter into an agreement to lease multiple floors in an office building. At commencement, it may not have been important for the entity to identify each floor as a separate lease component. However, if

[5] See paragraph 42 of IFRS 16.

the entity subsequently modifies the agreement to reduce the number of floors being leased from the lessor, the changes proposed by the ED may be applicable regardless of whether the entity originally identified each floor as a separate component at commencement.

Connecting the Dots

This amendment, which exempts entities from applying the lease modification framework for changes in a contract that reduce the contract's scope without economically affecting the remaining components, results in greater divergence with IFRS 16, under which a lease modification is defined in part as "a change in the scope of a lease."[6] In addition, this amendment may result in differences between the accounting for modifications under ASC 842 and that under ASC 606; the two Codification topics are currently substantially aligned in this respect.

At the September 18, 2020, roundtable, many participants, including Deloitte, indicated their support for the Board to consider amending the modification framework to improve the operability of the leasing standard and reduce unnecessary costs. Stay tuned for more information about potential future changes to the modification framework.

Adoption and Transition

The transition guidance in the ED states that entities that have not adopted ASC 842 would apply the transition requirements of ASU 2016-02 for all new and existing leases. The transition method would be either (1) retrospective for each period in the financial statements, with the cumulative effect of transition recorded at the beginning of the earliest period presented, or (2) retrospective at the beginning of the period of adoption, with a cumulative effect of transition recorded at the beginning of the period of adoption.

The ED states that for entities that have adopted ASC 842 before the effective date of this proposed ASU, the transition guidance would be as follows:

1. Issue 1 (sales-type leases with variable lease payments — lessor only) — An entity would have the option to apply the amendments in this proposed Update related to this issue either (a) retrospectively to leases that commence or are modified on or after the adoption of Update 2016-02 or (b) prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments in a final Update addressing the issues in this proposed Update.
2. Issue 2 (option to remeasure lease liability — lessee only) — An entity would have the option to apply the proposed amendments related to this issue either (a) retrospectively to leases that exist at or commence on or after the adoption of Update 2016-02 or (b) prospectively to leases that exist at or commence on or after the date that an entity first applies the amendments in a final Update addressing the issues in this proposed Update.
3. Issue 3 (modifications reducing the scope of a lease contract) — An entity would have the option to apply the proposed amendments related to this issue either (a) retrospectively to leases that are modified on or after the adoption of Update 2016-02 or (b) prospectively to leases that are modified on or after the date that an entity first applies the amendments in a final Update addressing the issues in this proposed Update.

Under the ED, an entity would be able to independently adopt and have a separate transition method for each of these three issues.

[6] See Appendix A of IFRS 16.

Appendix — Proposed ASU's Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for reference.

Issue 1: Sales-Type Leases With Variable Lease Payments — Lessor Only

Question 1: Are the amendments in this proposed Update operable? Why or why not?

Question 2: Should a lessor be required to classify and account for a sales-type lease with predominantly variable lease payments that do not depend on a reference index or a rate as an operating lease? Why or why not?

Question 3: Should "predominant" be the threshold for determining when a lessor should classify a lease with variable payments that do not depend on a reference index or a rate as an operating lease? Alternatively, would another threshold be more appropriate and operable (for example, "substantially all")? Please provide your rationale.

Question 4: Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?

Issue 2: Option to Remeasure Lease Liability — Lessee Only

Question 5: Are the proposed amendments operable? Why or why not?

Question 6: Should a lessee be provided with an option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not?

Question 7: Should a lessee be required to make an entity-wide accounting policy election to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not? If not, at what level should that accounting policy election be required to be applied?

Question 8: Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?

Question 9: Would the comparability of information be significantly affected by the option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based?

Issue 3: Modifications Reducing the Scope of a Lease Contract

Question 10: Are the proposed amendments operable? Why or why not?

Question 11: Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?

Question 12: Are there other aspects of the modification accounting model in Topic 842 that could be improved without compromising the decision usefulness of the information provided?

Transition

Question 13: For entities that have not adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the proposed amendments be applied at the date that an entity first applies Topic 842 using the same transition methodology in accordance with paragraph 842-10-65-1(c)? Why or why not?

Question 14: For entities that have adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the proposed amendments be applied either retrospectively or prospectively as described in this proposed Update? Why or why not?

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