

FASB Addresses Lessor Day-One Loss Issue for Certain Leases with Variable Payments

The FASB issued ASU 2021-05, *Leases (ASC 842), Lessors—Certain Leases with Variable Lease Payments*, (“Update”) to address the day-one loss issue related to a lessor’s accounting for certain leases with variable lease payments. [The Update](#) is effective for all entities in fiscal years starting after December 15, 2021. Early adoption is permitted.

Background

Under existing guidance in ASC 842, a lessor classifies a lease as either sales-type, direct financing, or operating based on specific classification criteria. In addition, a lessor excludes from the consideration in the contract, and therefore from lease payments, most variable payments other than those that depend on an index or a rate. For example, variable payments based on the performance or use of the underlying asset (such as the volume of electricity generated by a solar farm) are excluded from the consideration in the contract and from lease payments.

Depending on the magnitude of those variable payments, this may result in the recognition of a selling loss at the commencement date (a “day-one loss”) for a sales-type or direct financing lease if the amount of the net investment in the lease recognized is less than the carrying amount of the underlying asset derecognized. Those excluded variable payments are then recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur.

The Board received feedback from stakeholders that this accounting treatment does not reflect the economics of these transactions either at commencement or over the lease term. It is also inconsistent with the accounting for such leases as operating leases under ASC 840, *Leases* based on an interpretation of the classification guidance applicable to lessors that was not retained in ASC 842.

Main Provisions

Under the Update, a lessor will classify a lease with variable lease payments that do not depend on an index or a rate as operating if the following two conditions are met:

- The lease would be classified as a sales-type or direct financing lease,
- Doing so would result in recognizing a selling loss.

In those situations, a lessor will continue to recognize the underlying asset. The underlying asset will also continue to be subject to other GAAP, such as ASC 360 on property, plant, and equipment, including impairment guidance. Any fixed lease payments will be recognized in income on a straight-line basis, while any variable payments will continue to be recognized when the changes in facts and circumstances on which those variable payments are based occur.

Effective Dates and Transition

The Update is effective for all companies in fiscal years starting after December 15, 2021. Public companies are required to adopt the Update in interim periods during the fiscal year starting after December 15, 2021 while other entities will adopt the Update in interim periods starting after December 15, 2022. Early adoption is permitted.

Entities that have not adopted ASC 842 by the issuance date of this Update (July 19, 2021) will apply this Update when adopting ASC 842 using the existing transition guidance in ASU 2016-02, Leases (ASC 842).

For entities that have already adopted ASC 842 as of July 19, 2021, there are two options to apply the changes in this Update:

- Retrospective adoption to leases that commenced or were modified on or after the adoption of ASC 842 and that were not accounted for as a separate contract, or
- Prospective adoption to leases that commence or are modified on or after the adoption date of this Update and that are not accounted for as a separate contract.

Certain transition disclosures are also required.

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