

# Center for Plain English Accounting

AICPA's National A&A Resource Center

## ASU 2021-05

### Lessors—Certain Leases with Variable Lease Payments

On July 19, 2021, the FASB issued Accounting Standards Update (ASU) 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*. As part of the post-implementation review (PIR) of leases (FASB *Accounting Standards Codification* (FASB ASC) 842), the FASB was made aware of an issue being encountered by lessors wherein following the guidance in FASB ASC 842 requiring them to recognize a loss at lease commencement for certain sales-type lease with variable payments, even if the lessor expects the arrangement will be profitable overall.

This situation arises because a lessor is required under FASB ASC 842 to exclude variable lease payments that are not based on rate or on an index from initial recognition of the net investment in the lease. As a result, the amount initially-recognized as an asset for the net investment in the lease could be less than the carrying value of the underlying asset that is derecognized by the lessor- thus creating the day-one loss. Variable lease payments are then recognized into income by the lessor in the period when changes in facts and circumstances on which the variable lease payments are based occur. The result in these situations does not match the underlying economics, which results in the financials potentially being less valuable to users.

Lease arrangements in which a day-one loss would occur for lessors are common in several industries with energy and consumable goods being most prevalent.

The amendments included in this update amend lease classification requirements for lessors. This amendment does not apply to lessees. A lessor is now required to classify and account for a lease with variable payments as an operating lease if:

- a) the lease would have been classified as a sales-type lease or a direct financing lease and
- b) the lessor would have otherwise recognized a day-one loss

As a result, a day-one loss or profit is not recognized under operating lease accounting, which address the concerns identified as part of PIR in this area and would improve the decision usefulness of the financial statements.

### Effective Date and Transition

The amendments are effective for fiscal years beginning after December 15, 2021, for all entities, and interim periods within those fiscal years for public business entities and interim periods within fiscal years beginning after December 15, 2022, for all other entities. Early adoption is permitted.

Entities that have not adopted FASB ASC 842 should follow the transition requirements of FASB ASC 842. This transition is either retrospective to each prior period presented in the financial statements with the cumulative effect of transition recognized at the beginning of the earliest period presented or retrospective to the beginning of the period of adoption with a cumulative effect of transition recognized at the beginning of the period of adoption.

Entities that have adopted FASB ASC 842 before the issuance date of this ASU have the option to apply the amendments either retrospectively to leases that commenced or were modified on or after the adoption of FASB ASC 842 or prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments.

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