

## Center for Plain English Accounting

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### **FASB ASC 842 & “Month-to-Month Leases” Determination of Lease Term**

By: [Thomas Groskopf](#)

With respect to leases, the term “month-to-month” is often casually used to describe the duration of the lease. With the adoption of FASB *Accounting Standards Codification* (FASB ASC 842), we have found that the informal use of the term “month-to-month” can cause confusion when tasked with making a technical determination of lease term as defined in FASB ASC 842. Many private companies also are considering how to arrange common control leases in light of FASB’s current [project](#) with some attempting to qualify these leases for the short-term lease exception in FASB 842 from balance sheet recognition. In this report, we detail the considerations and frequently encountered issues when applying FASB ASC 842’s lease term concept to a lease that is informally characterized as “month-to-month.”

#### Lease Term Under FASB ASC 842

FASB ASC 842 defines the lease term as:

The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor

FASB ASC 842-10-55-23 to 55-24 also indicate:

An entity should determine the noncancellable period of a lease when determining the lease term. When assessing the length of the noncancellable period of a lease,

an entity should apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1(b). If only a lessor has the right to terminate a lease, the lease term includes the period covered by the option to terminate the lease, as described in paragraph 842-10-30-1(c).

With respect to what are described as “month-to-month” leases, we often are asked about what the appropriate lease term is under FASB ASC 842. To answer this question, it is important to examine the rights and obligations of the parties to the contract and avoid generalities. Many of these leases have clauses which address renewals which may or may not convey enforceable rights. It is important to look at these closely to see if those provisions convey the option for the lessee to extend the lease. In some cases, the lessee and lessor must agree on terms and conditions to extend the lessee. If that is the case, the lessee does not have a right to extend the lease as it must receive consent from the lessor to do so. Since this arrangement lacks enforceable rights, it would not be considered under FASB ASC 842. In the next section, we further discuss the accounting treatment under FASB ASC 842 for common provisions which some may be loosely described as a “renewal” and how these common provisions impact the determination of lease term.

- Automatic rollover provisions or “evergreen” leases
- Mutual Options to Renew (or Terminate) and “At-Will” Renewal Options
- Notice provisions

***Practice Note:*** If a lease has a provision that does convey the option for the lessee to extend the lease, the lessee will need to make a determination of which periods under the option are reasonably certain to be exercised. Reasonably certain is a relatively high threshold and does require significant economic incentive under FASB ASC 842-10-30-2. Periods that are deemed reasonably certain to be extended by the lessee under a lessee option to extend the lease are included in the lease term under FASB ASC 842.

### Automatic Rollover or “Evergreen” Leases

In some situations, a “month-to-month” lease has a provision which automatically renews a lease unless either the lessor or the lessee terminates the lease. In these situations, to determine the lease term under FASB ASC 842, an entity must first determine if the lease is no longer enforceable if both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant

penalty. If a more than insignificant penalty exists, then the lessee would determine the period that it is reasonably certain not to exercise its termination option (note that the lessor is assumed to not exercise its termination option). If a more than insignificant penalty does not exist, enforceable rights and obligations do not exist and the lease term would not cover the period under the mutual termination option. It is important to note in making this determination that the FASB ASC broadly defines “penalty” and includes disbursements of cash, performing services, incurring (or assuming) liability, and surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment.

In situations with automatic rollover clauses, determination of the lease term can involve significant judgment and on-going lease term reassessments. The following example illustrates this situation.

**Example-** Boum, Inc (lessee) leases construction equipment for a daily rental rate that renews daily unless terminated by the lessee by returning the equipment. No significant penalties are involved in the arrangement. The lessee makes an initial determination of lease term based on days in which renewal is reasonably certain. During this period, the lessee would then need to consider whether a reassessment event under FASB ASC 842-10-35-1 takes place and, if so, reevaluate the number of days they are reasonably certain to not terminate the lease. If the lessee continues to lease the construction equipment at the end of the previously determined lease term, a reassessment event would take place under FASB ASC 842-10-35-1c which would then require the lessee to reevaluate lease term again.

**CPEA Observation:** Lease term reassessment triggers were significantly expanded in FASB ASC 842 and now include subjective and objective triggering events. The triggering events are:

- an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease or
- the lessee elects to exercise an option even though the lessee had previously determined that the lessee was not reasonably certain to do so (or vice versa) or
- a significant event or significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease

As a result, in the context of the daily rental example above, if the lease term is determined to be daily, lease term reassessments triggering events also will be at least daily unless the lessee returns the construction equipment.

Lessees may wonder about the practical implications of this required reassessment, specifically, how frequently they would need to pay substantive attention to a lease term determination in the context of indefinite daily rental arrangements and renewals. In making this assessment, we note the following considerations which could drive a risk of material misstatement to the financial statements:

- Frequency of U.S. generally accepted accounting principles (U.S. GAAP) compliant financial statements (monthly, quarterly, annual)
- Magnitude of fixed lease payments under automatic renewal leases
- Requirement to disclose short term lease cost for lease terms greater than one month
- Application of short-term lease exception from balance sheet recognition and measurement

#### *Short-term Lease Exception and Automatic Rollover/Evergreen Leases*

The short-term lease exception, if elected, is an important consideration in the determination of lease term for evergreen lease arrangements. FASB ASC 842-20-25-3 is of particular importance.

If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the remainder of the guidance in FASB ASC 842 as if the date of the change in circumstances is the commencement date.

We have noted some confusion about the applicability of the short-term lease exception if a subsequent renewal of the lease extended the lease term beyond one year. It is important to note that FASB ASC 842-20-25-3 disqualifies a lease from the short-term lease exception if “after the change, the remaining lease term extends more than 12 months from the *end of the previously determined* lease term...”. (emphasis added). Further, Basis of Conclusion (BC) 379 of ASU 2016-02, *Leases (Topic 842)*, notes the FASB acknowledged that the short-term lease exception could be applied to evergreen leases. In BC 381 of ASU 2016-02, the FASB further noted that application of the short-term lease exception could result in, “a lease that ultimately extends for 10 years or more could be structured as a 1-year lease with a series of 1-year renewal options, which could result in the lease never being recognized on a lessee’s statement of financial position.”

## Mutual Options to Renew (or Terminate) or “At-Will” Renewal Options

Many “month-to-month” leases contain mutual renewal options by which both the lessee and the lessor must agree to exercise a renewal, otherwise, the lease term ends. After the noncancelable period is over, such mutual renewal options effectively render the lease an “at-will” arrangement and, generally, do not convey an enforceable option to continue the lease. The FASB ASC Master Glossary defines a lease by reference to the FASB ASC Master Glossary definition of a “contract” which is an “an agreement between two or more parties that creates enforceable rights and obligations.” Accordingly, when the contract is no longer enforceable, the definition of a “lease” is not satisfied, and the provisions of FASB ASC 842 do not apply. A lease renewal option controlled by the lessee should be an enforceable option to continue the lease.

## Notice Provisions

Some “month-to-month” leases also will contain notice provisions whereby, a party to the lease must give the counterparty notice before a termination right can be exercised. Therefore, these notice periods can create enforceable rights and obligations. For example, if the lease requires a 90-day notice period to terminate and creates a noncancelable right and obligation during the 90-day notice period, there would be an enforceable term on a rolling 90-day basis. In such a case, the agreement may fall under the short-term lease exemption but would be subject to the disclosure requirement in FASB ASC 842-10-50-4 (note that there is an exception from this disclosure if the lease term is one month or less). Leases with notice provisions also can have renewal options controlled by the lessee which also would need to be considered in making the determination of lease term under FASB ASC 842.

## Interaction with Proposed ASU on Common Control Arrangements

We previously [reported](#) on the FASB’s proposed practical expedient for private companies and not-for-profits that are not conduit debt obligors to use written terms and conditions of a related party arrangement between entities under common control to determine whether that arrangement is or contains a lease. Under the proposal, if an entity determines that a lease exists, that entity shall classify and account for that lease on the basis of those written terms and conditions. The proposal would amortize leasehold improvements for related party leases under common control over the economic life of the improvements. This is intended to address practice questions regarding leasehold improvement amortization periods which are truncated by lease term in some related party leases under common control.

If these proposed changes are finalized, many have observed that qualifying entities would be incentivized to structure “month-to-month” leases to avail themselves of the short-term lease exception. While disclosures of these leases would be required under

both FASB ASC 842 (short-term lease cost among other requirements) and FASB ASC 850, *Related Party Disclosures*, (related party transactions), balance sheet recognition would be avoided. We note for those considering structuring “month-to-month” leases for related party arrangements, that a level of administrative diligence may be required to maintain the short-term lease exception that goes beyond that which typically is seen for related party leases under common control.

If a “month-to-month” lease expires, an entity would find that written terms no longer exist and, therefore, would be disqualified from the practical expedient and need to consider FASB ASC 842 as currently written (proposed FASB ASC 842-10-15-3B). This could include a [challenging legal determination](#) at expiration regarding explicit and implied enforceable terms and conditions in common control arrangements. However, if renewal clauses or automatic rollover clauses are used to avoid the aforementioned undesirable consequences of expiration of a “month-to-month” lease, a separate potentially challenging determination of the reasonably certain lease term will need to be made that could disqualify the entity from the short-term lease exception. For example, if automatic rollover provisions are used and more than insignificant “penalties” to termination exist (such as abandoned leasehold improvements), a lease likely would continue to be in effect (and, therefore, the practical expedient could continue to be used), but the lessee would need to walk through the process described in the above section to determine the reasonably certain lease term.

In many cases with related party leases under common control, significant economic incentives (such as leasehold improvements) will exist to cause renewal options controlled by the lessee to be included in the lease term, causing the lease term to potentially exceed one year, and disqualify the lease from the short-term lease exception. In these situations, it would appear that, to maintain the short-term lease exception, the private company will need to regularly maintain written leases without renewal options controlled by the lessee that could cause the lease term to exceed one year.

If a private company was not interested in maintaining use of the short-term lease exception, an option to consider would be automatic rollover provision that terminates at some number of years into the future. While a reasonably certain lease term still would need to be considered for the period which the automatic rollover applies, this consideration would be limited to the period the automatic rollover applies. The downside here is that entities will need to remember to update the termination date for automatic rollover provisions to avoid lacking a written lease and not qualifying for the written terms and conditions practical expedient.

On February 15, 2023 the FASB voted to finalize the Proposed ASU on common control arrangements with minor clarifications. The FASB staff anticipated a Final ASU issued

by the end of March 2023. We will continue to report and analyze this situation as the proposed changes are finalized.

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