Leases: Real estate lessors

Handbook

US GAAP

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Contents

Foreword 1

About this publication 2

1. Scope and definition of a lease 4

2. Separating components of a contract 19

3. Lessor accounting 40

4. Other considerations 94

5. Transition 132

Appendix

Index of changes 150

KPMG Financial Reporting View 151

Acknowledgments 152

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A real estate lessor's guide to lease accounting

Calendar year-end private entities were required to adopt the leases standard (Topic 842) on January 1, 2022. Non-calendar year-end private entities adopted on the first day of their fiscal year beginning after December 15, 2021 (e.g. April 1, 2022 for a private entity with a March 31 year-end). As a result, as of the date of this publication, most private entities have now issued financial statements reflecting the adoption of Topic 842, while those who have not yet done so, soon will.

KPMG Handbook, Leases (the Handbook) is updated periodically with new and updated interpretations. The Handbook illustrates how Topic 842 applies to common transactions, provides examples about common scenarios, explains our emerging thinking on key interpretative issues, and compares the Topic 842 requirements to legacy US GAAP.

This publication provides a road map to the Handbook's existing technical guidance on key issues that are likely to be of interest to real estate lessors and focuses on the implications for US GAAP reporting entities. This publication is not intended to provide guidance incremental to the Handbook, but rather serves to highlight the guidance that is most relevant to real estate lessors.

KPMG Handbook, Revenue: Real estate Q&As, primarily addresses issues when applying the revenue model under Topic 606 to sales of real estate, but also addresses some of the common questions about the interaction of Topic 606 and Topic 842. Using those Q&As along with this publication may be helpful when considering the interplay between the revenue and leases standards.

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About this publication

Purpose

The purpose of this publication is to assist you in understanding how the requirements of Topic 842, Leases, may apply to transactions common to real estate lessors. In June 2022 and May 2023, we updated our Handbook, Leases (the Handbook) with new and updated interpretations. The Handbook provides in-depth analysis and our perspective on Topic 842's requirements and may be useful to readers of this publication in better understanding the concepts of Topic 842.

This publication provides a road map to our existing technical guidance on key issues that are likely to be of interest to real estate lessors and focuses on the implications for US GAAP reporting entities. This publication is not intended to provide incremental guidance but serves to highlight the guidance that is most relevant to real estate lessors and is intended to be used as a companion to the Handbook and our Hot Topics series on Leases.

Organization of the text

The publication is in a Q&A format and is organized into sections that largely reflect the flow of Topic 842. Our guidance refers to the FASB Accounting Standards Codification®. For example, 842-10-25-1 is paragraph 25-1 of ASC Subtopic 842-10.

This publication is intended for use by preparers and other interested parties with a working knowledge of the existing real estate leases guidance and an understanding of the new leases model. Users should consult the Handbook and our Hot Topics for a baseline understanding of the leases model and interpretive guidance on its concepts. Cross-references are provided throughout this publication.

Reference to the new and old standards

We refer to the new leases standard as 'Topic 842' and the old leases standard as 'Topic 840' throughout this publication. The new revenue recognition standard is referred to as 'Topic 606'.

Interaction with the revenue recognition standard

As you read this Q&A, you may be surprised by the level of interaction with the revenue recognition guidance, Topic 606, Revenue from Contracts with Customers. The link between the two standards acknowledges the FASB's view that leasing is, in effect, a revenue generating activity for lessors.

For a deeper understanding of the requirements of Topic 606, see the latest news on KPMG Financial Reporting View. The website includes our Handbooks, Revenue recognition and Revenue: Real estate Q&As.

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December 2023 edition

This edition includes new and updated interpretations based on our experience with companies implementing Topic 842, and discussions with industry and preparer groups, and the FASB and SEC staffs. This addition also includes new material addressing the amendments to Topic 842 enacted by ASU 2023-01, Common Control Arrangements.

New Questions added in this edition are identified throughout the publication with **. Items that have been significantly updated or revised are identified with #.

Future developments

Although most companies have now adopted Topic 842, questions remain, and interpretations of Topic 842 continue to evolve. This means that some positions may change, and positions on new issues will emerge.

For the Questions in this publication where we are aware of ongoing discussions and the potential for a position to change, we have indicated that in our interpretive response.

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1. Scope and definition of a lease

Detailed contents

New item added in this edition: **

1.1 Scope

Questions

1.1.10 Land easements

1.1.20 Accounting for sales with repurchase rights by suppliers and customers

1.2 Definition of a lease

Common Control Arrangements **

Questions

1.2.10 Perpetual land easements

1.2.20 Time-based land easements

1.2.30 Rights to capacity portions of an asset

1.2.40 Secondary use – advertising space

1.2.45 Secondary use – building rooftop **

1.2.50 Percentage rent in the right to use retail space

1.2.60 Functional independence

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1.1 Scope

Topic 842 is an inclusive standard and applies to all leases (including subleases) unless there is a specific scope exclusion. The following are the specific scope exclusions from Topic 842. [842-10-15-1]

Excludes leases of/to …	Commentary
Intangible assets	Intangible assets and rights to use intangible assets continue to be accounted for under Topic 350 (goodwill and other intangibles).
Explore for or use non-regenerative resources (e.g. minerals, oil or natural gas)	— The scope exclusion includes the intangible right to explore for those natural resources, and rights to use the land in which those natural resources are contained, unless those rights of use include more than the right to explore for natural resources (e.g. the right to explore and/or develop land). — Rights to use equipment used to explore for natural resources are in the scope of Topic 842.
Biological assets (e.g. crops)	The scope exclusion includes leases of timber, to be consistent with Topic 840.
Inventory	Inventory is a defined term in US GAAP; only leases of assets that meet that definition are excluded from the scope of Topic 842. However, consider the following: — A determination of whether the asset is 'inventory' should be from the perspective of the customer (lessee) – i.e. whether the asset would be inventory or instead an item of property, plant or equipment for the customer (lessee). The arrangement should not be scoped out of Topic 842 solely because the asset was classified as inventory by the supplier (lessor). Manufacturers and dealers frequently lease assets such as vehicles or machinery that they classify as 'inventory' because they both sell and lease them to customers. — The description of an asset as 'inventory' does not in itself mean that a lease of that asset is outside the scope of Topic 842. For example, sometimes entities refer to a collection of assets, such as spare parts, as inventory. If those spare parts are depreciable assets under other accounting guidance, a right to use those assets is in the scope of Topic 842.
Assets under construction	— If a lessee controls the asset under construction before the commencement date of the lease, the transaction is in the scope of the sale-leaseback guidance. — Topic 842 includes guidance (and examples) about when a lessee controls an asset that is under construction before lease commencement, and guidance on accounting for costs associated with the construction or design of the underlying asset in a lease.

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Excludes leases of/to ...	Commentary
	Section 9.4 in the Handbook discusses determining when a lessee controls an asset that is under construction and the resulting accounting.

The scope of Topic 842 does not exclude long-term leases of land (e.g. 99- or 999-year leases). Although such long-term leases may be economically similar to the purchase or sale of land, the Board decided against a scope exclusion. This was principally because there is no conceptual basis for differentiating long-term leases of land from leases of other assets, and inevitably any definition of a long-term lease of land would be arbitrary. [ASU 2016-02.BC113]

Topic 842 fundamentally retains the scope of the legacy leasing guidance, which means that there are only minor differences in scope between Topic 842 and Topic 840. [ASU 2016-02.BC110]

Chapter 2 in the Handbook addresses scope. Specifically, the following guidance may be particularly relevant to real estate lessors.

Natural resources scope exclusion – rights of use in addition to natural resource rights	Question 2.1.15
Natural resources scope exclusion – different parties own the mineral rights and the land	Question 2.1.20
Natural resources scope exclusion – adjacent land rights	Question 2.1.30
Natural resources scope exclusion – various scenarios	Example 2.1.10
Sales of out-of-scope nonfinancial assets with seller repurchase right or obligation	Question 2.3.20
Comparison to legacy US GAAP	Paragraphs 2.4.20–2.4.50

Question 1.1.10
Land easements

Are land easements in the scope of Topic 842?

Interpretive response: Yes. Land easements are in the scope of Topic 842 because an easement is, by nature, a right to use identified property. Therefore, a land easement should be accounted for as a lease if it meets the definition of a lease. However, Topic 842 has a transition practical expedient that allows an entity to grandfather its accounting for land easements that commence before the effective date.

Additional guidance about the accounting for land easements is provided in Questions 1.2.10 and 1.2.20 in this publication and in the following places in the Handbook.

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The applicability of Topic 842 to land easements	Question 2.3.10
Evaluating whether a perpetual land easement is a lease	Question 3.1.10
Evaluating whether a floating easement is a lease	Question 3.2.20
Applying the transition practical expedient for land easements (effective date method of transition)	Section 13A.2.4
Applying the transition practical expedient for land easements (comparative method of transition)	Section 13B.2.4

Question 1.1.20
Accounting for sales with repurchase rights by suppliers and customers

How might the accounting for sales with repurchase rights be different for suppliers vs customers?

Background: In addition to those transactions in the scope of Topic 842, some arrangements in the scope of Topic 606 or Topic 610 (other income), in which an entity sells a nonfinancial asset to another party, but with the right or obligation to repurchase that asset from the customer, are accounted for as leases by the supplier. [606-10-55-66 – 55-78, ASU 2014-09.BC427]

— **Forward or call option.** If an entity sells an asset and has an obligation or a right to repurchase the asset, the entity accounts for the arrangement as a lease if it can or must repurchase the asset for an amount that is less than its original selling price. [606-10-55-68, ASU 2014-09.BC427]

— **Put option.** If an entity sells an asset and has an obligation to repurchase the asset at the customer's request, the entity accounts for the arrangement as a lease if the customer has a 'significant economic incentive' to require the entity to repurchase the asset. [606-10-55-72]

Interpretive response: Topic 606 and Topic 610 do not apply to the customer in a sale transaction. Consequently, the customer in a sale transaction that will be accounted for as a lease by the supplier will not account for that transaction as a lease unless the arrangement meets the definition of a lease in Topic 842.

We believe customers in these arrangements with repurchase provisions may still conclude that they have purchased the asset even if Topic 606 or Topic 610 requires the supplier to account for the transaction as a lease.

Question 2.3.30 in the Handbook provides additional guidance.

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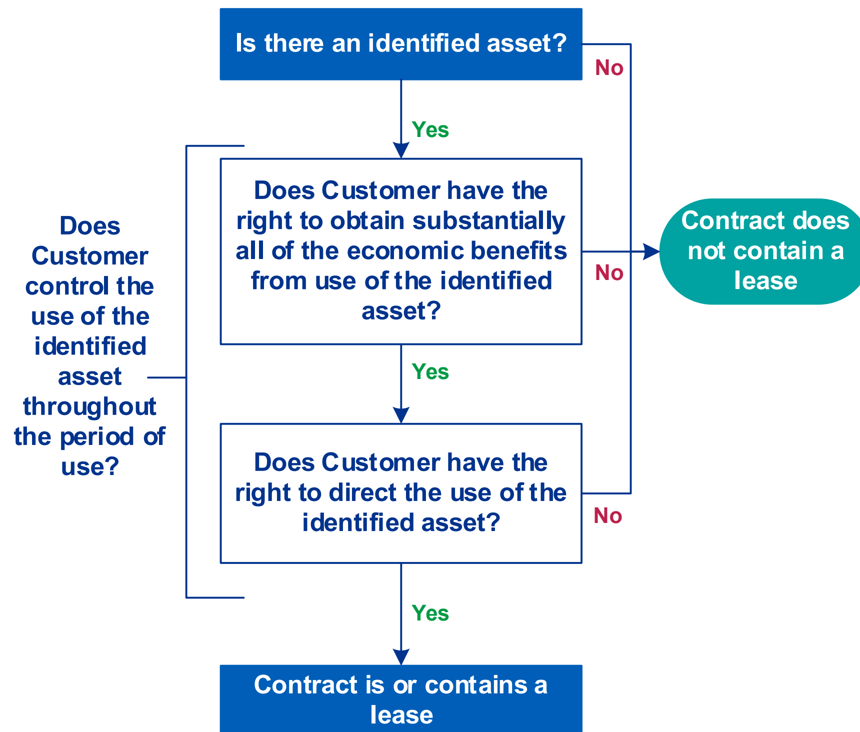
1.2 Definition of a lease

A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (land or a depreciable asset) for a period of time in exchange for consideration.

The following are the key elements of the definition.



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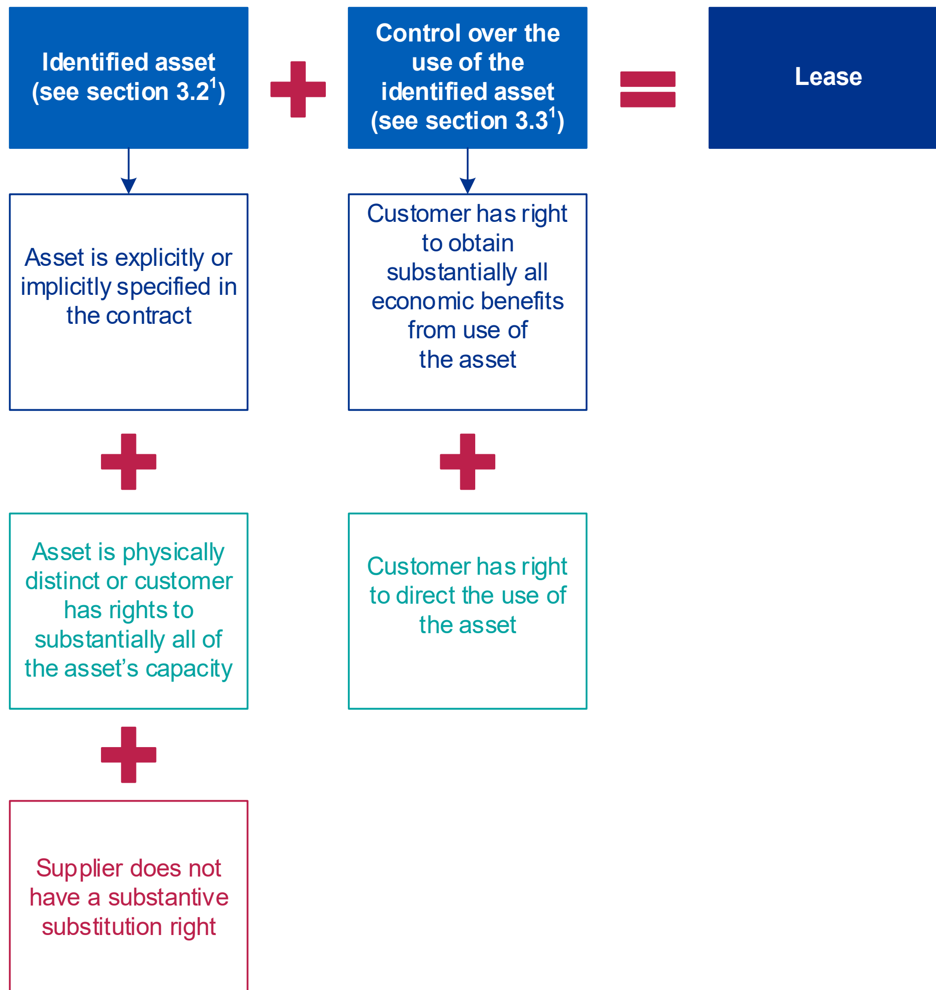
The following diagram highlights the two conditions required to meet the definition of a lease, plus the specific tests that must be passed to meet those conditions.



Note:

1. Sections reference to the Handbook

Both parties to a contract (the customer and the supplier) evaluate at *inception* of the contract whether it is or contains a lease. An entity does not reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6 – 15-7]

*Common Control Arrangements***

For arrangements that exist between related parties under common control, an entity may elect, on an arrangement-by-arrangement basis, a practical expedient to use the written terms and conditions of a common control leasing arrangement (without regard to enforceability) to determine whether a lease

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exists and, if so, the classification of and accounting for that lease. This practical expedient is available to an entity that is not: [842-10-15-3A]

- a public business entity;
- a not-for-profit entity that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market; or
- an employee benefit plan that files or furnishes financial statements with or to the US Securities and Exchange Commission.

If the written terms and conditions convey the practical (as opposed to enforceable) right to control the use of an identified asset for a period of time in exchange for consideration, the entity classifies and accounts for that lease on the basis of those written terms and conditions. [842-10-15-3A]

If there are no written terms and conditions, the entity cannot use the practical expedient; instead, it identifies the legally enforceable terms and conditions to determine whether a lease exists and, if so, uses those terms and conditions in applying Topic 842. [842-10-15-3B]

Chapter 3 in the Handbook addresses accounting for situations that arise when an arrangement to which the practical expedient has been applied ceases to be between entities under common control.

Evaluating whether there is an 'identified asset'

An identified asset may be explicitly or implicitly specified in a contract. In most cases, the asset that is the subject of the lease will be explicitly specified in a contract – e.g. by serial number, or a specified floor of a building. In that case, there is an identified asset unless the supplier has a substantive right to substitute the specified asset. [842-10-15-9]

An asset is implicitly specified in a contract if fulfillment of the contract depends on an item of property, plant or equipment (e.g. a piece of equipment) and the supplier does not have a substantive right to substitute alternative assets to fulfill the contract – e.g. the supplier has only one piece of equipment or facility to fulfill the contract. [842-10-15-9, ASU 2016-02.BC128]

If the supplier has a substantive substitution right throughout the period of use, there is no identified asset, and therefore the contract does not contain a lease. A substitution right is substantive when the supplier: [842-10-15-10]

- has the practical ability to substitute alternative assets throughout the period of use; and
- would benefit economically from the exercise of its substitution right – i.e. the economic benefits that will be derived from substituting the asset exceed the costs of the substitution; for example, costs to transport/relocate the original and the alternative asset, and associated labor costs.

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Evaluating whether the customer 'controls the use of the asset'

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use. This includes direct benefits (e.g. from using, holding or subleasing the asset) and other economic benefits related to the use of the asset (e.g. renewable energy credits received, or byproducts arising from the use of an asset) that could be realized in a commercial (arm's length) transaction. [842-10-15-17, ASU 2016-02.BC135]

A contract may require a customer to pay a portion of the cash flows derived from the use of an asset to the supplier (or another party) as consideration; this does not prevent the customer from obtaining substantially all of the economic benefits from use of that asset. For example, a customer may be required to pay the supplier a percentage of sales as consideration for use of retail space. The cash flows from those sales are considered economic benefits that the customer receives, a portion of which it then pays to the supplier as consideration for the right to use the retail space. [842-10-15-19]

We believe the Board's intent with this provision was to establish that the customer obtaining the economic benefits from use of the asset (e.g. the cash flows obtained from selling products in a leased retail store) generally is separate from its payment of a portion of those cash flows to the supplier as additional rent. Variable payments of this nature should not affect the identification of a lease any differently from fixed payments that are often made with cash flows generated from use of the asset. Fixed or variable payments may be significant compared to the economic benefits generated by use of the asset (e.g. in high-rent locations), and we believe the Board intended that the amount of the payments for the right to use the asset (even if significant as compared to the economic benefits to be derived from the use of that asset) generally should not affect the conclusion about whether a lease exists.

In addition, a customer must have the right to direct the use of the asset. The customer has that right if it has control over those decision-making rights about the use of the asset that are most relevant to (i.e. those that most significantly affect) the economic benefits that can be derived from the asset's use. Decisions about how and for what purpose the asset is used during the period of use are most relevant to the economic benefits that can be derived from the asset's use.

Significant judgment may be required when the supplier has physical possession of, operates and maintains the identified asset, including careful consideration of which decisions each party controls and which of those decisions are most relevant – i.e. most significantly affect the economic benefits that can be derived from use of the asset.

It is possible that neither the customer, nor the supplier, controls relevant decisions about how and for what purpose an identified asset will be used throughout the period of use because those decisions are predetermined. In that case, the customer nevertheless has the right to direct the use of the asset if: [842-10-15-20(b)]

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— it has the right to operate the asset or direct others to operate it in a manner it determines throughout the period of use (and the supplier has no right to change those operating decisions); or

— it designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways – e.g. by the design of the asset or by the terms of the contract, such as through contractual restrictions on the use of the asset. [842-10-15-21]

Chapter 3 in the Handbook addresses the definition of a lease. Specifically, the following additional guidance about the definition of a lease may be particularly relevant to real estate lessors.

Meaning of 'consideration' – e.g. when there is no stated consideration or the consideration is noncash or in-kind	Question 3.1.20
Observations about Topic 842 lease definition compared to Topic 840	Paragraphs 3.1.60–3.1.100
Period of use vs contract term	Question 3.1.40
Unit of account is each identified asset vs separate lease component	Question 3.2.10
Determining whether the asset is specified in the contract	Paragraphs 3.2.10–3.2.40
Determining whether the asset is physically distinct	Paragraph 3.2.50
Determining whether an asset's primary use affects whether a lease exists	Question 3.2.40
Rooftop space asset identification	Example 3.2.15**
Evaluating substitution rights	Paragraphs 3.2.80–3.2.150
Determining identified assets (storage facility and land use examples)	Example 3.2.40
Implicitly specified land asset with substitution rights	Example 3.2.60
Comparison to legacy US GAAP	Paragraphs 3.2.160–3.2.170
Determining the scope of the customer's right to use the asset	Paragraphs 3.3.60–3.3.100
Contractual restrictions affecting whether or not there is a lease	Question 3.3.20
Identifying the economic benefits from use of the asset	Paragraphs 3.3.110–3.3.130
Evaluating the substance of economic benefits from use	Question 3.3.30

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Analyzing economic benefits from use of an asset	Question 3.3.39
Supplier use of the identified asset	Question 3.3.45
Whether economic benefits include tax attributes	Question 3.3.50
Evaluating 'substantially all'	Paragraphs 3.3.140–3.3.160 Question 3.3.60
Fixed economic return from identified asset	Question 3.3.70
Determining whether the customer has the right to direct the use of the asset	Paragraphs 3.3.170–3.3.260
Evaluating whether operational decisions are relevant when evaluating who controls the use of the asset	Question 3.3.100
Construction services contract	Example 3.3.50
Leases when the supplier has physical possession of, operates and maintains the identified asset	Question 3.3.130
Construction subcontractor arrangement (scaffolding)	Example 3.3.62
Right to direct the use of the identified asset – billboards	Example 3.3.76
Evaluating control when the 'how and for what purpose' decisions are predetermined	Paragraphs 3.3.270–3.3.330
Construction subcontractor arrangement (perimeter fencing)	Example 3.3.95

Question 1.2.10
Perpetual land easements

Does a perpetual land easement meet the definition of a lease?

Interpretive response: No. This is because a lease conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. Because the right to use the land granted by the easement is perpetual, we believe it lacks an essential characteristic of a lease – i.e. that the grantee controls a right to use the land only for a period of time. Rather, a perpetual land easement is, in effect, a form of *ownership of a portion of* the land.

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Additional guidance about the accounting for land easements is provided in Question 1.1.10 in this publication and in the following places in the Handbook.

The applicability of Topic 842 to land easements	Question 2.3.10
Additional background and guidance about perpetual land easements	Question 3.1.10
Evaluating whether a floating easement is a lease	Question 3.2.20
Applying the transition practical expedient (effective date method of transition)	Section 13A.2.4
Applying the transition practical expedient (comparative method of transition)	Section 13B.2.4

Question 1.2.20
Time-based land easements

Does a time-based land easement meet the definition of a lease?

Interpretive response: We believe the analysis of whether a lease exists differs depending on whether the easement grants the right to use surface or subsurface (i.e. underground) land.

Surface land rights

If an easement grants a lessee rights to use surface land, that land is the unit of account for evaluating whether a lease exists. This is regardless of whether another entity has rights to use the subsurface land (e.g. to bury a telecommunications cable or a pipeline).

Therefore, if the grantee has exclusive rights to use the identified surface land, we believe a land easement will typically meet the definition of a lease.

In contrast, if the easement only grants nonexclusive rights to use the identified surface land, a lease does not exist.

Subsurface land rights

There are presently mixed views about whether a lease exists for subsurface land easements.

Under one view (View 1), the land should be subdivided by surface rights and subsurface rights, which may be further subdivided into multiple subsurface rights by depth. If the grantee has exclusive use of an identified subsurface portion of the land, the easement would typically meet the definition of a lease.

However, an alternative view (View 2) exists that certain subsurface rights are akin to air rights (which are contract-based intangible assets), and thus are outside the scope of Topic 842. The view does not equate all subsurface land easements to air-use rights. For example, rights to use underground land for a

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retail or other similar store (e.g. in a subway station), which will be used in a manner consistent with surface land, are not analogous to air-use rights.

In the absence of further guidance from the FASB or the SEC staff, we will accept either view, applied consistently.

Contract grants both surface and subsurface land rights

A contract that grants explicit rights to use both the surface of the identified land and defined subsurface space may include two units of account.

An entity that applies View 1 for the subsurface land rights would conclude that there are two units of account: the surface land rights and the subsurface land rights. This is unless the effect of separate accounting is insignificant – e.g. because the rights are co-terminus and each lease would be classified as an operating lease if classified separately.

An entity that applies View 2 for the subsurface land rights would conclude that there are two units of account: a separate lease component for the right to use the surface land, and a non-lease component for the right to use the subsurface land. This is unless the entity elects (and meets the criteria to apply) the practical expedient not to separate lease and non-lease components.

We do not believe an entity should *infer* that subsurface rights exist in a contract that explicitly grants surface land use rights only unless subsurface rights are explicitly granted. In other words, it would be inappropriate for an entity to assign a portion of its fixed payments for the surface land lease to an implicit subsurface rights component.

Question 3.3.90 in the Handbook provides additional guidance about how to evaluate surface and subsurface land rights.

Question 1.2.30
Rights to capacity portions of an asset

Is a capacity portion of an asset (for example, a warehouse) an identified asset?

Interpretive response: Most capacity portions are not identified assets. A customer will generally not have decision-making rights as to how the asset is used if it has rights to only a capacity portion of an asset (that is not substantially all of the asset's capacity). [ASU 2016-02.BC133]

However, a capacity portion of an asset can be an identified asset if: [842-10-15-16]

— it is physically distinct – e.g. the floor of a building or specific room within a storage warehouse; or

— it is not physically distinct, but the customer has the right to receive substantially all of the capacity of the asset – e.g. substantially all of the data capacity of a fiber-optic cable.

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Determining whether a capacity portion of an asset is a lease can be relevant for many different asset types. However, warehouse capacity is a common example that requires consideration.

The following additional guidance about evaluating warehouse arrangements is provided in the Handbook.

Additional guidance about evaluating capacity portions	Paragraphs 3.2.50–3.2.70
Assessing whether there is a physically distinct asset in a warehouse lease	Example 3.2.10
Supplier's practical ability to substitute alternative assets	Question 3.2.60
Assessing whether substitution rights in a warehouse lease are substantive	Example 3.2.20
Assessing whether there is an identified asset when the contract grants the right to use multiple physically distinct storage spaces	Example 3.2.40
Implicitly specified land asset with substitution rights	Example 3.2.60
Right to direct the use of the identified asset – storage warehouse	Example 3.3.70
Right to direct the use of the identified asset is predetermined – storage warehouse	Example 3.3.90

Question 1.2.40

Secondary use – advertising space

Is the space on the side of a building that the customer uses to advertise always an identified asset?

Interpretive response: No. We believe there are two acceptable views.

One view is that the advertising space is an identified asset and could be leased if the customer controls its use.

The other view is that the advertising space is not an identified asset because the primary purpose of the side of the building is to enclose the interior of the building; the outside aspect (i.e. layer) of the wall, is not physically or mechanically separable from the remainder of that wall. On that basis, no lease exists because the advertising space customer is not obtaining substantially all of the economic benefits from use of the larger identified asset.

Question 3.2.40 in the Handbook provides additional guidance about how to consider an asset's primary and secondary use when determining whether there is an identified asset (necessary for a lease to exist).

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Question 1.2.45**

Secondary use – building rooftop

Is the space on the rooftop of a building that the customer uses an identified asset?

Interpretive response: Yes. In most cases, we believe a rooftop is akin to the top floor of the building (albeit without a roof) – i.e. encompassing not *just* the surface of the roof, but the useful space above that surface where, for example, an entity may operate a rooftop bar or restaurant, or use it as outdoor space for residential tenants. These uses are generally the primary use of that space. An entity may also primarily use that space to attach valuable equipment (e.g. antennae, cellular towers, solar panels). Specific facts and circumstances will need to be considered when evaluating rooftop scenarios.

Question 3.2.40 in the Handbook provides additional guidance about how to consider an asset's primary and secondary use when determining whether there is an identified asset (necessary for a lease to exist).

Question 1.2.50

Percentage rent in the right to use retail space

Does a customer's requirement to pay the supplier a percentage of sales prevent it from obtaining substantially all the economic benefit from the use of the space?

Interpretive response: No. The cash flows from the sales are considered economic benefits that the customer receives, a portion of which it then pays to the supplier as consideration for the right to use the retail space. We believe that the customer obtaining the economic benefits from use of the asset (e.g. the cash flows obtained from selling products in a leased retail store) generally is separate from its payment of a portion of those cash flows to the supplier as additional rent. [842-10-15-19]

However, there may be situations in which the customer retains only a fixed return on the use of the identified asset or has only minimal exposure/upside from the use of the asset. In those cases, the customer may not have the right to obtain substantially all of the economic benefits from the use of the asset, and therefore may not have a lease.

Paragraphs 3.3.150–3.3.160 in the Handbook provide additional guidance about evaluating payments to the supplier of a portion of the asset's cash flows and Question 3.3.70 provides guidance specifically about situations in which the customer retains only a fixed return.

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Question 1.2.60
Functional independence

If an asset does not function independently of other supplier-owned or supplier-leased assets, is that asset still capable of being leased?

Interpretive response: Yes. An asset's dependency on one or additional other assets for the customer to be able to derive economic benefits from use of the asset does not determine whether there is or is not a lease. For example, a contract between an office building owner and a tenant for exclusive use of the 23rd floor can still meet the definition of a lease even though the customer's ability to derive benefit from use of the 23rd floor depends on, for example, floors 1–22, the elevators used to access the 23rd floor, and the common areas through which all occupants of the building (and their visitors) must transit to access their office space. [ASU 2016-02.BC142(c)]

Question 3.3.110 in the Handbook provides additional guidance.

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2. Separating components of a contract

Detailed contents

2.1 Overview

2.2 Step 1: Identify the separate lease components

Questions

2.2.10 Separating lease components – land

2.2.20 Land and multi-tenant building

2.3 Step 2: Identify non-lease components

Questions

2.3.10 Assessing the number of CAM components

2.3.15 Capital replacements and repairs

2.3.20 Property taxes and insurance – lessor or lessee costs

2.3.30 Property taxes and insurance – accounting for gross and net leases

2.3.40 Sales and other similar taxes

2.4 Step 3: Measure the consideration in the contract

Questions

2.4.10 Measuring consideration in a contract – lessor cost reimbursements and percentage rent

2.4.20 Variable payments for CAM in a net lease

2.5 Step 4: Separate and allocate consideration between the lease and non-lease components

Questions

2.5.05 Non-separation practical expedient – meaning of 'associated with'

2.5.10 Lessor practical expedient – operating lease classification criterion

2.5.20 Lessor practical expedient – same pattern of transfer requirement

2.5.30 Lessor practical expedient – evaluating predominance

2.5.35 Lessor practical expedient – lease and services are not co-terminus

2.5.40 Stand-alone selling price for CAM provided by the lessor at a loss

2.5.50 Variable payments that do not depend on an index or rate and the consideration in the contract

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2.1 Overview

If a contract is, or contains, a lease, the entity follows these steps in accounting for the components of the contract:

- **Step 1:** Identify the separate lease components.
- **Step 2:** Identify any non-lease components – e.g. a maintenance or operating service.
- **Step 3:** Measure the 'consideration in the contract'.
- **Step 4:** Separate and allocate the consideration in the contract between the lease and non-lease components.

Lessees may elect to account for non-lease components as part of the lease component to which they relate. This election is made by class of underlying asset, and the combined component is accounted for a single *lease* component.

Lessors have a similar option with two main differences:

- the lease and non-lease components must meet specified criteria to qualify to be combined; and
- the combined component is accounted for under Topic 606 (i.e. as a single performance obligation), rather than under Topic 842 if the non-lease element(s) of the combined component is (are) 'predominant'; otherwise, the combined component is accounted for as an operating lease.

Section 2.5 of this publication includes additional guidance on the application of the lessor practical expedient to not separate certain lease and non-lease components. Additionally, chapter 4 in the Handbook addresses separating components of a contract.

2.2 Step 1: Identify the separate lease components

A right to use an underlying asset (i.e. a lease), or a bundle of such rights, is a separate lease component if both of the following criteria are met: [842-10-15-28]

- the lessee can benefit from the right of use either on its own or together with other resources readily available to the lessee.
- the right of use is neither highly dependent on nor highly interrelated with the other right(s) to use the underlying assets in the contract.

Notwithstanding these criteria, the right to use land should be treated as a separate lease component unless the accounting effect of doing so would be insignificant (consider Questions 2.2.10 and 2.2.20 in this publication for additional guidance).

For each separate lease component, an entity:

- assesses lease classification for the separate lease component; and
- applies the recognition and measurement requirements of Topic 842.

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Section 4.1 in the Handbook addresses identifying the separate lease components. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Identifying lease components	Paragraphs 4.1.10–4.1.70
Comparison to legacy US GAAP	Paragraphs 4.1.160–4.1.190

Question 2.2.10

Separating lease components – land

Is the land element of the lease always accounted for separately from the building?

Interpretive response: It depends. For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the right to use the land is considered a separate lease component unless the accounting effect of separately accounting for the land element would be 'insignificant' – e.g. separating the land element would have no effect on classification or the amount that would be recognized for the land lease component is insignificant. [842-10-15-29]

Topic 842 does not define insignificant. Consequently, determining whether the effect of accounting for a land lease element as a separate lease component would be insignificant may require significant judgment in some cases. [ASU 2016-02.BC147]

The following additional guidance about whether to separate the land lease component is provided in the Handbook.

Evaluating whether separate accounting for the land lease component is 'insignificant'	Paragraphs 4.1.80–4.1.100 Question 4.1.10
Observations about the complexity of the land separation analysis	Paragraphs 4.1.110–4.1.150
Identifying lease components in a lease of land, building and integral equipment	Example 4.1.20
Identifying lease components in a lease of land and building when the lease term is for a major part of the building's remaining economic life	Example 4.1.30

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Question 2.2.20
Land and multi-tenant building

Does a lease of space in a multi-tenant building include a lease of the underlying land that must be evaluated for separation?

Interpretive response: It depends. In many multi-tenant lease arrangements – e.g. a lease of retail space in a shopping mall or office space in a multi-tenant building – we do not believe there is a lease of the underlying land because (a) the lessee does not have the right to control the use of any physically distinct portion of the land underlying the building, and (b) no single lessee in the multi-tenant building is likely to have control over its use. Therefore, neither the lessee nor the lessor needs to evaluate the land separation criteria.

However, a land lease component may exist if the lessee is leasing substantially all of the building.

Question 4.1.20 in the Handbook provides additional guidance.

2.3 Step 2: Identify non-lease components

A contract might contain non-lease components in addition to lease components – e.g. an arrangement to lease office space with the lessor responsible for common area maintenance (CAM). CAM generally includes maintaining the common areas (e.g. restrooms, food court, lobby) and grounds. Activities may include landscaping, janitorial services, snow removal and repairs. CAM is a non-lease component of the contract because it transfers a service to the lessee other than the right to use the underlying real estate. Although CAM is a non-lease component, it may qualify for the lessor practical expedient to not be accounted for separately from the lease component, which is more fully explained in section 2.5 of this publication. [842-10-15-31]

However, not every element of a contract that contains a lease is necessarily a 'component'. While it may be intuitive to assume that any activity or payment that is not a lease component or an explicit 'lease payment' must be a non-lease component, this is not how Topic 842 works. Instead, some elements of a contract may not be components at all because they do not transfer a good or service to the lessee. [842-10-15-30]

Contract		
Lease components	Non-lease components	Not a component
Allocate consideration in the contract (Step 4)		Activities (or lessor costs) that do not transfer a good or service to the lessee

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Examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include a lessee's reimbursement of the lessor's property taxes and insurance. Therefore, although fixed payments to the lessor intended to reimburse it for those costs are part of the 'consideration in the contract', in Step 4 they are allocated only to the separate lease and non-lease components. [842-10-15-30]

Variable payments to the lessor to reimburse it for **its** costs are not part of the consideration in the contract but will be allocated to the separate lease and non-lease components when recognized. The only exception to this is when the lessor elects the sales and other similar taxes practical expedient that was added to Topic 842 by ASU 2018-20 (see sections 5.1 and 5.2 of this publication).

The sales tax practical expedient provides a lessor with an accounting policy election to present all funds collected from lessees for sales and other similar taxes net of the related sales tax expense. 'Sales and other similar taxes' refers to taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction. Other similar taxes include use, value added taxes (VAT) and some excise taxes. Such taxes **exclude** (1) gross receipts taxes and (2) taxes assessed on the lessor as owner of the underlying asset, such as most property taxes. [842-10-15-39A, ASU 2018-20.BC14]

A lessor electing this practical expedient must apply it to all leases, disclose its policy election and comply with the disclosure requirements in Topic 235 (notes to financial statements). [842-10-15-39A, 842-30-50-14]

Variable payments to the lessor that are **lessee** costs are not part of the lessor's lease accounting – the lessor recognizes neither the cost nor the lessee's payment thereof. As more fully explained in Questions 2.3.20–2.3.40, and 3.2.20 in this publication, costs that the lessee pays directly to a third party are accounted for as lessee costs. [842-10-15-40A]

Section 3.2 in this publication and section 7.3.2 in the Handbook provide additional guidance on gross versus net presentation of variable payments and the sales and other similar taxes practical expedient.

Section 4.2 in the Handbook addresses identifying non-lease components. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Identifying non-lease components	Paragraphs 4.2.10–4.2.40
Components in Topic 842 equivalent to promised goods or services in Topic 606	Paragraphs 4.2.50–4.2.60
CAM as a non-lease component	Question 4.2.10
Comparison to legacy US GAAP (maintenance, including CAM)	Paragraphs 4.2.70–4.2.100
Lessor costs in net leases – gross vs net	Paragraphs 7.3.160–7.3.200 Paragraphs 7.3.260–7.3.300 Paragraph 7.4.25

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Sales and other similar taxes	Paragraphs 4.2.170–4.2.220 Paragraphs 7.3.210–7.3.250 Paragraphs 7.3.310–7.3.320 Paragraph 7.4.25

Question 2.3.10

Assessing the number of CAM components

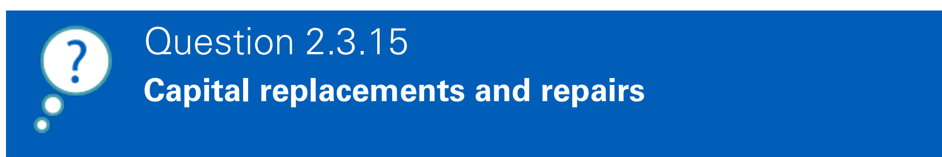
Is CAM a single non-lease component or does CAM encompass multiple non-lease components?

Interpretive response: Whether CAM is a single non-lease component or multiple non-lease components is assessed based on the performance obligations guidance in Topic 606 – Step 2 of the Topic 606 revenue model (see chapter 4 of KPMG Handbook, Revenue recognition).

We believe the nature of CAM is such that it will frequently comprise only a single performance obligation under Topic 606; therefore, it will be a single non-lease component when allocating the consideration in the contract under Topic 842.

However, the characterization of an activity as part of CAM does not necessarily mean it is not a separate non-lease component – i.e. separate from the other activities that are part of CAM. There is no single or standard definition of CAM; therefore, lessors may characterize items that are not part of fulfilling the promise to the lessee to maintain the common areas of the building as part of CAM. This may include billing for those items together with CAM or as part of a single CAM billing. Entities will need to evaluate what promised lessor activities are truly part of fulfilling CAM, and separately account for those that provide a different or incremental benefit to the lessee *beyond* maintaining the common areas of the property.

Question 4.2.20 in the Handbook provides additional guidance about how to analyze the number of CAM components.



Question 2.3.15

Capital replacements and repairs

Is a lessor's replacement or repair of the asset's essential structure a non-lease component?

Background: A lessor frequently has the contractual right to pass through costs of capital replacements or repairs to its tenants. For example, if a lessor installs a new roof on its property (i.e. part of its essential structure), the tenants may be required to reimburse the lessor for those costs. A common reimbursement arrangement is for tenants to reimburse the lessor consistent with the useful

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life of the replacement/repair and consistent with the lessees' proportionate rights to use the property.

In determining how to account for those lessee reimbursements, a key first question is whether the capital replacement/repair is a non-lease component of the contract.

Interpretive response: It depends on whether the capital replacement/repair is a promise to the lessee. This would be so if the particular replacement/repair is either:

- promised in the lease contract; or
- an activity necessary to fulfill another lessor performance obligation (e.g. CAM).

If a particular capital replacement or repair is a promise to the lessee, the lessor will need to determine whether that particular replacement/repair is a separate performance obligation under Topic 606, or instead is part of another performance obligation such as CAM – i.e. one of many fulfillment activities necessary to satisfy that performance obligation.

Using CAM as an example, *necessary* repairs to the property's roof are part of the CAM performance obligation. Maintaining the roof is a fulfillment activity of the CAM; it is not an additional performance obligation that is separate from other CAM fulfillment activities such as cleaning/maintaining the customer restrooms, food court, parking lot, and/or parking garage.

In contrast, a capital replacement or repair that is not a promise to the lessee (as described above) is similar to property tax or insurance costs that a lessor incurs as owner of the property. Typically, this replacement or repair will benefit the lessor's asset for many years past the lease terms of existing tenants at the time of the replacement or repair. Because this action does not fulfill a promise to a particular lessee, a requirement for the lessee to reimburse the lessor for the replacement/repair is substantively the same as a requirement for the lessee to reimburse the lessor for its property tax or insurance costs.

Question 3.2.55 in this publication addresses lessor accounting for lessee reimbursements of capital replacements and repairs that are not promises to the applicable lessee.

This guidance is reproduced from Question 4.2.25 in the Handbook.

Question 2.3.20

Property taxes and insurance – lessor or lessee costs

Are property tax or insurance payments required by a lease contract costs of the lessor or executory costs of the lessee?

Interpretive response: A lessee's reimbursement of the lessor's property taxes and insurance costs is an example of an activity that does *not* transfer a good or service to the lessee. Accordingly, those payments are not specifically allocated to a separate contract component.

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Before issuance of ASU 2018-20 in December 2018, a lessor applied the same considerations as a lessee to determine whether a variable payment was for a lessor cost or lessee cost.

After adopting ASU 2018-20, for lessors only, property taxes and insurance on the underlying asset are accounted for as:

- **lessee costs** if the lessee remits the tax or pays the insurance premium directly to the relevant third party – e.g. the taxing authority or insurer;
- **lessor costs** if the lessor remits the tax or pays the insurance premium to the relevant third party and receives reimbursement from the lessee.

The lessor undertakes no additional analysis such as that required of lessees, to determine whether the property taxes or insurance are lessee or lessor costs. In other words, for lessors, it does not matter whether they are the primary obligor for a property tax or the primary beneficiary of insurance on the underlying asset. Whether the property tax or insurance is a lessee or a lessor cost is determined solely by which party (lessee or lessor) pays the relevant taxing authority or insurer.

A lessor's accounting for a lessee's reimbursement or payment of property tax and insurance costs is not affected by lease classification.

Question 4.2.40 in the Handbook provides additional guidance about the lessee's accounting for property taxes and insurance.

Additional guidance about a lessor's accounting for costs paid by the lessee is provided in section 3.2 and Question 3.2.20 in this publication, and in the Handbook as follows.

Taxes and insurance	Question 4.2.40 Paragraphs 4.2.110–4.2.160
Variable payments of lessor costs made directly to a third party recognized net by lessors	Paragraphs 4.4.224–4.4.225
Whether lease classification affects the lessor's accounting for costs paid by the lessee	Question 4.2.45

Question 2.3.30

Property taxes and insurance – accounting for gross and net leases

How does the accounting by a lessor for property taxes and insurance differ for gross and net leases?

Interpretive response: In gross leases, payments of lessor costs directly to the lessor are fixed as part of the rental payment. Those payments are included in the 'consideration in the contract,' which the lessor allocates to the lease and non-lease components that it accounts for separately.

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In net leases, lessees make variable payments to the lessor or directly to a third party for costs associated with the leased asset. Such costs paid directly to a third party by the lessee are not part of the lease accounting. [842-10-15-40A]

In contrast, variable payments made to the lessor for such costs, while not part of the 'consideration in the contract', will not be excluded from lease accounting in a net lease scenario). Depending on whether the contract also includes non-lease components, either all or a portion of the variable payments for the property taxes or insurance will be accounted for as variable lease payments. Lessees and lessors will need to track such variable lease payments for disclosure purposes – i.e. disclosures of variable lease income. [842-10-15-40 – 15-40A, 842-30-50-5(c)]

Additional guidance about a lessor's accounting for costs reimbursed by the lessee in a gross lease versus a net lease is provided in section 3.2 in this publication, and in the Handbook as follows.

Guidance on accounting and presentation for gross leases and net leases	Questions 4.2.50
Identifying components in gross and net leases that include property tax and insurance reimbursements	Example 4.2.20
Accounting for property tax and insurance reimbursements in a gross lease	Example 4.2.30
Accounting for property tax and insurance reimbursements in a net lease – lessee reimburses lessor	Example 4.2.40
Accounting for property taxes and insurance in a net lease – lessee pays third party directly	Example 4.2.50

Question 2.3.40
Sales and other similar taxes

Are sales and other similar taxes paid by the lessee part of the consideration in the contract?

Interpretive response: A lessor's accounting first depends on whether it elects the sales and other similar taxes practical expedient (see paragraphs 4.2.200–4.2.210 in the Handbook).

Lessor elects the practical expedient – in-scope taxes

The lessor accounts for all 'in-scope' taxes as lessee costs, rather than evaluating whether each tax in each taxing jurisdiction is a lessee or a lessor cost. This is true regardless of who remits payment of the tax to the taxing authority.

This means that the tax and the lessee's payment thereof will be presented net of each other (i.e. with zero effect) in the lessor's income statement.

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Lessor elects the practical expedient – out-of-scope taxes

Even if a lessor has elected the sales and other similar taxes practical expedient, it follows the guidance for a lessor that has not elected the practical expedient (see below) for out-of-scope taxes. Section 2.3 in this publication addresses in-scope and out-of-scope taxes.

Lessor does not elect the practical expedient

The first step for a lessor that does not elect the practical expedient is to determine whether the applicable tax is a lessee or a lessor cost. This approach also applies to taxes that are outside the scope of the practical expedient regardless of the lessor's election.

The tax is a lessee cost if the lessee remits the tax directly to the relevant taxing authority. In contrast, the tax is a lessor cost if the lessor remits the tax to the taxing authority and receives reimbursement for the tax amount from the lessee (see section 3.2 and Question 3.2.20 in this publication). It does not matter which party (lessee or lessor) is primarily obligated for the tax. [842-10-15-40A]

If the tax is a lessee cost

The lessor's accounting for the tax and the lessee's payment thereof is the same as for in-scope taxes for a lessor electing the sales and other similar taxes practical expedient. The tax and the lessee's payment thereof will be presented net of each other (i.e. with zero effect) in the lessor's income statement.

If the tax is a lessor cost

The lessor should recognize lessee reimbursements of costs that it receives and pays directly on a gross basis – i.e. as additional lease income with the cost recognized as an operating expense.

Section 3.2 and Question 3.2.20 in this publication and Questions 4.2.60 and 4.2.70 in the Handbook provide additional guidance on how to account for sales and other similar taxes.

2.4 Step 3: Measure the consideration in the contract

The next step for lessors is to measure the consideration in the contract.

The starting point for a lessor measuring the consideration in the contract is the defined payments in paragraph 842-10-30-5 relating to the use of the underlying asset (see section 5.4 in the Handbook), The consideration in the contract then also includes fixed (and in-substance fixed) payments reduced for incentives paid (or payable) to the lessee.

In addition, a lessor includes in the consideration in the contract certain variable payments. Which, if any, variable payments are included depends on the nature of the payments and whether the lessor is applying the practical expedient not to separate non-lease components.

The following flowchart summarizes the lessor's process for evaluating variable payments in the contract when either:

— the lessor has elected to separate lease and non-lease components – i.e. has *not* elected the practical expedient; or

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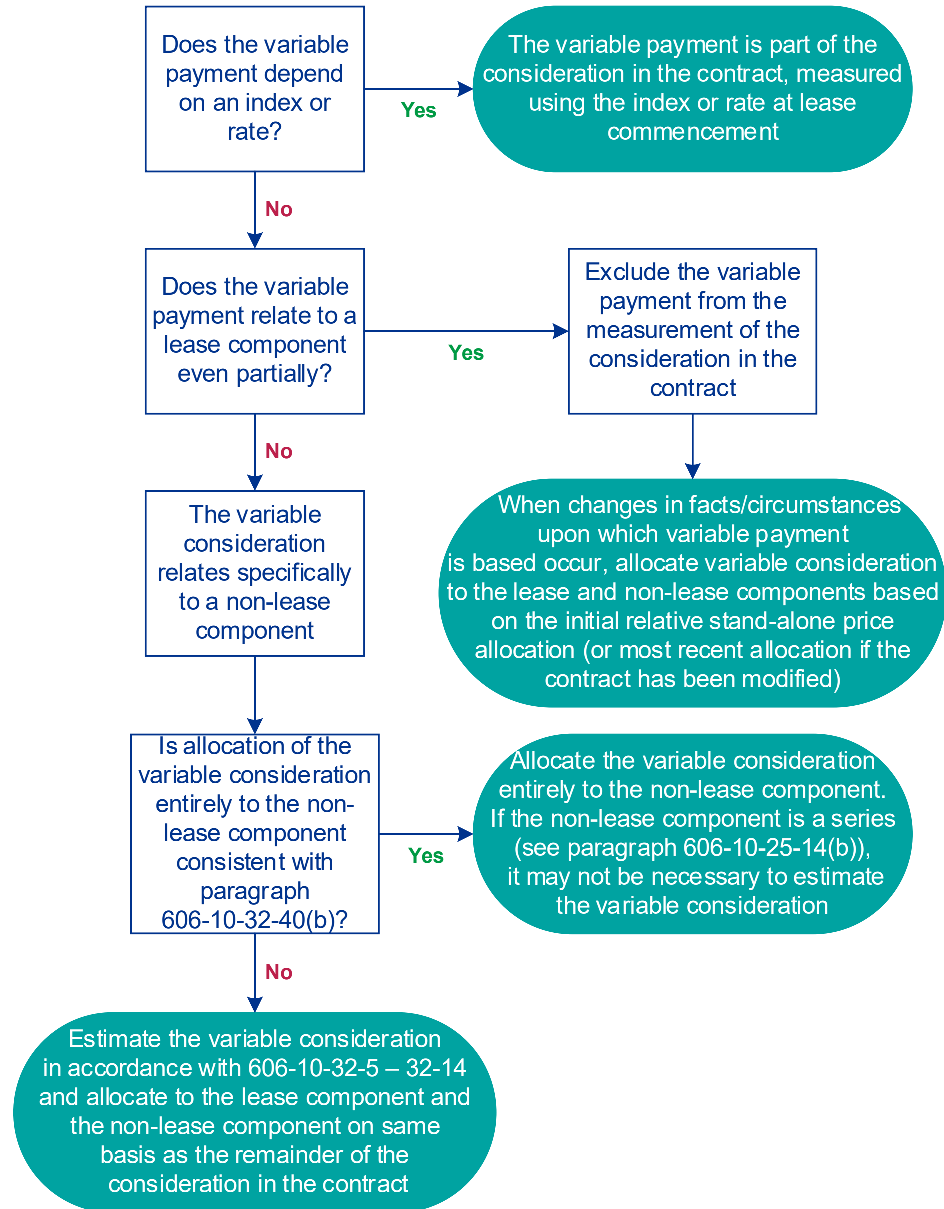
— the contract contains at least one lease component (including a combined lease component) and one or more non-lease components that do not qualify to be combined with the lease component.



If a lessor has elected to not separate lease and non-lease components that qualify for the non-separation practical expedient, and, as a result, the contract contains only (1) lease components or (2) non-lease performance obligations accounted for under Topic 606, the model flowcharted in the preceding paragraph does not apply. Rather, if application of the practical expedient results in only: [842-10-15-42B, ASU 2018-11.BC33, 842-10-15-40]

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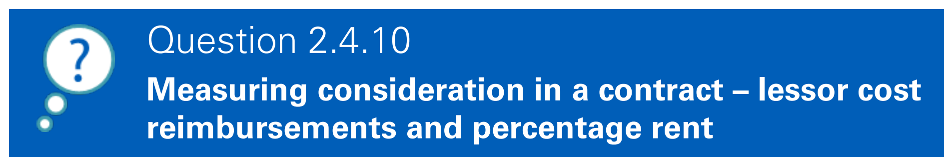
— **Lease components**, all variable payments that do not depend on an index or rate (and are not in-substance fixed payments) are excluded from the measurement of the consideration in the contract, regardless of whether there are variable payments that relate specifically to a non-lease element of the combined component (or an outcome from transferring a non-lease element that is part of the combined component).

— **Topic 606 performance obligations**, then all variable payments are accounted for in accordance with the variable consideration transaction price guidance in Topic 606 (see chapter 4 of KPMG Handbook, Revenue recognition), even if those variable payments relate (wholly or partially) to the lease element of the combined performance obligation (component). [606-10-32-5 – 32-14]

Section 4.3 in the Handbook addresses measuring the consideration in the contract. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Measuring the consideration in the contract	Paragraphs 4.3.50–4.3.75
Timing of measurement, including when two or more lease components have different commencement dates	Question 4.3.40
Observations about differences between Topic 842 and Topic 606 for lessors	Paragraphs 4.3.90–4.3.130
Comparison to legacy US GAAP (variable lease payments)	Paragraphs 4.3.140–4.3.150



Question 2.4.10

Measuring consideration in a contract – lessor cost reimbursements and percentage rent

Are a lessee's payments to the lessor for property taxes, insurance and percentage rent included in the consideration in the contract?

Interpretive response: No. Property tax and insurance reimbursements and percentage rent – i.e. rental payments that are based on the use of the leased real estate – are variable payments that *at least* partially relate to the lease component, and that do not depend on an index or rate.

Question 4.3.10 in the Handbook provides additional guidance about what types of variable payments are excluded from the consideration in the contract.

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Question 2.4.20

Variable payments for CAM in a net lease

Are variable payments for CAM included in the consideration in the contract when amounts that will be billed are unknown at lease commencement? If so, how are those amounts measured?

Interpretive response: Yes. The lessor's estimate of variable CAM charges is included in the consideration in the contract, unless the CAM is part of a combined operating lease component (i.e. because the lessor has elected the practical expedient not to separate it as a non-lease component). This is because variable CAM charges specifically relate to the CAM non-lease component. The lessor's estimate of CAM charges to which it will be entitled during the lease term is determined based on the guidance in paragraphs 606-10-32-5 – 32-14 – i.e. based on a most likely amount or expected value method estimate, subject to the constraint on variable consideration. [842-10-15-39]

Under some lease contracts the lessor may bill for other non-lease items together with, or characterized as, CAM that are not part of CAM. For example, utilities for a retail or office space may be provided to the lessee by the lessor and billed together with, or as part of, CAM. In the case of non-lease goods or services other than CAM such as utilities, variable payments that specifically relate to those items will follow the same requirements as for variable payments that are for CAM.

However, lessors should ensure they do not include in their estimate of variable CAM charges variable payments for items bundled together with CAM that relate to either lease components or costs that are not components at all (e.g. property taxes or building insurance). Such amounts are not estimated or included in the consideration in the contract.

This guidance is reproduced from Question 4.3.20 in the Handbook. Example 4.3.10 illustrates how to determine the consideration in the contract in three scenarios and includes discussion of the lessor's accounting when it does and when it does not elect the practical expedient to not separate non-lease components.

2.5 Step 4: Separate and allocate consideration between the lease and non-lease components

Non-lease components are separated from related lease components unless the applicable lessee or lessor non-separation practical expedient applies. Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP. [842-10-15-31]

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A lessor allocates the consideration in the contract to each separate lease and non-lease component to depict the amount of consideration to which the lessor expects to be entitled (i.e. consistent with the 'allocation objective in Topic 606 – see chapter 6 of KPMG Handbook, Revenue recognition). [842-10-15-38, 606-10-32-28]

The lessor will generally allocate the consideration in the contract to each separate lease component and each non-lease component on a relative basis in proportion to its stand-alone selling price.

If an observable price (i.e. the price at which the lessor sells that component separately in similar circumstances and to similar customers) is available, the lessor uses the observable price.

While GAAP does not preclude or prescribe any particular method for estimating the stand-alone selling price of a good or service when observable stand-alone selling prices are not available, it describes three estimation methods as suitable approaches – the adjusted market assessment approach, the expected cost plus a margin approach and a residual approach. [606-10-32-34]

If variable payments are included in the consideration in the contract for a lessor, they are allocated entirely to the non-lease component(s) to which they relate if that would be consistent with the transaction price allocation objective in Topic 606. If the lessor does not allocate those variable payments entirely to the non-lease component(s) to which they relate, it allocates them on the same basis as the remainder of the consideration in the contract. [842-10-15-39; 606-10-32-39]

If variable payments are not included in the consideration in the contract, they are allocated to the lease and/or non-lease components. Variable payments are generally allocated to the contract components consistent with how the consideration in the contract was initially allocated. [842-10-15-40, 55-152]

A lessor recognizes the portion of such variable payments allocated to:

- the separate lease component as revenue in the period in which the changes in facts and circumstances on which those payments are based occur, and
- the non-lease component(s) as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

Lessor practical expedient

As a practical expedient, a lessor may elect not to separate non-lease components that would be within the scope of Topic 606 if accounted for separately from associated lease components when two specific criteria are met. Those criteria are: [842-10-15-42A]

a. The timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
b. The lease component, if accounted for separately, would be classified as an operating lease.

If the practical expedient has been elected and a contract includes multiple non-lease components – one or more that meet(s) the timing and pattern of transfer criterion and one or more that does(do) not – the lessor combines the non-lease

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component(s) that meet the criterion with the lease component and separates any non-lease components that do not. [842-10-15-42C]

If the non-lease component(s) is(are) the predominant component(s) of the combined component, the lessor should account for the combined component under Topic 606, as a single Topic 606 performance obligation, rather than the leases guidance in Topic 842. All other combined components are accounted for under Topic 842 as a single operating lease component. [842-10-15-42B]

In many cases, determining whether to account for the combined component as a single lease component or as a single non-lease component in the scope of Topic 606 will be simple. For example, in most real estate lease scenarios it will be clear that the lease is the predominant element of the combined component.

A lessor elects this practical expedient by class of underlying asset and not type of lease – e.g. gross versus net leases. [842-10-15-42A]

Section 4.4 in the Handbook addresses separating and allocating consideration between lease and non-lease components. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Applying the lessor practical expedient to not separate non-lease components	Paragraphs 4.4.51–4.4.63
Practical expedients for lessees and lessors not limited to insignificant non-lease components	Question 4.4.10
Identifying a 'class of underlying asset'	Question 4.4.11
Accounting for a gross lease with CAM and cost reimbursements	Example 4.2.30
Accounting for a net lease with CAM and cost reimbursements	Example 4.2.40
Allocating consideration in the contract (when the lessor practical expedient is not applied)	Paragraphs 4.4.100–4.4.140
Allocation on a relative stand-alone price basis	Questions 4.4.30–4.4.50 Paragraphs 4.4.150
Standalone selling price estimation methods – residual approach (lessors)	Question 4.4.55
Allocating consideration when there are multiple lease and multiple non-lease components	Question 4.4.60
Allocating consideration in related party leases	Question 4.4.65#
Comparison to legacy US GAAP (separating lease and non-lease components)	Paragraphs 4.4.160–4.4.180
Allocating variable consideration in the contract	Paragraphs 4.4.190–4.4.200
Allocating percentage rent in a real estate lease that includes CAM and cost reimbursements	Example 4.4.40
Allocating variable payments not included in the consideration in the contract	Paragraph 4.4.220 Example 4.4.50
Subsequent changes to the consideration in the contract	Paragraphs 4.5.30–4.5.50

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Observation about allocating subsequent changes to the consideration in the contract after a modification or remeasurement	Paragraph 4.5.60
Combining two or more contracts	Section 4.6

Question 2.5.05

Non-separation practical expedient – meaning of 'associated with'

How should entities interpret 'associated with' when applying the lessor non-separation practical expedient?

Background: Section 2.5 describes the practical expedient available to lessors that permits them to not separate non-lease components from lease components to which they relate.

A lessor may elect (by class of underlying asset) to account for each separate lease component and the non-lease components **associated with** that lease component as a single component if: [842-10-15-42A]

— the non-lease components otherwise would be accounted for under Topic 606 (revenue from contracts with customers); and
— two additional criteria are met (see Questions 2.5.10 and 2.5.20 in this publication).

In practice, questions have arisen about whether and how 'associated with' affects an entity's ability to combine a non-lease component with a lease component, including how it applies to contracts that contain:

— multiple separate lease components; and
— non-lease components that specifically relate to the lessee's owned assets (or assets leased from an unrelated third-party lessor).

Interpretive response: We believe the 'associated with' language was included principally to ensure that non-lease components are combined with the lease component(s) to which they relate when the contract contains multiple separate lease components.

For example, if a lease contains two leases of property – e.g. land and building, each of which is a separate lease component, and maintenance on both, the 'associated with' language in the practical expedients means that:

— the maintenance associated with the land lease should be combined with the land lease component; and
— the maintenance associated with the building lease should be combined with the building lease component.

Assigning non-lease components to separate lease components could affect the accounting for the contract. For example, combining the fixed payments for a non-lease component with the wrong lease component could result in incorrect lease classification for either the combined component or another separate lease component. The fixed non-lease payments might incorrectly result in finance lease classification for the combined component, or operating

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lease classification for the separate lease component with which the non-lease component should have been combined.

Non-lease components related to an asset owned by the lessee or leased from a lessor that is not a party to the contract

A lease contract might include non-lease services (e.g. maintenance or operations) for property the lessee owns or leases from a lessor that is not a party to the contract. For example, a lessor might lease property to a lessee and in addition to maintaining that property, contract to maintain the lessee's owned property.

When a non-lease component specifically relates to one or more assets the lessee owns or leases from a lessor that is not a party to the contract, it should not be combined with a separate lease component of the contract. The same concerns with respect to multiple separate lease components arise in this situation. Combining the non-lease component with (one of) the separate lease component(s) could change the accounting for both – e.g. if it changes the classification of the lease.

The contract might not discuss multiple non-lease components. That is, it might not outline multiple maintenance or operations services, even though the services pertain to both assets leased from the lessor and other owned or leased assets. In that case, the contract's description of the services singularly, rather than as multiple services, should not change the entity's accounting; the entity should allocate the consideration for the single enumerated service between the combined lease component (the lease and the services associated with that leased asset) and a non-lease service component (the service associated with the lessee's owned asset).

Other situations

So far this response illustrates circumstances in which it is clear that a non-lease component is associated with a particular asset (leased or owned). Those circumstances may frequently exist; for example, it may be clear to which asset(s) maintenance or operations services relate. However, the association may not always be clear. Topic 842 offers no guidance on whether or how an entity should assess whether a non-lease component is associated with a lease component in those cases. Therefore, judgment will be required.

One approach (there may be others) that we believe may be acceptable in making this evaluation is to consider the nature of the relationship between the lease and the non-lease component. This includes how dependent the lessee's ability to use or derive benefit from the non-lease good(s) or service(s) is on the lease.

The following example considerations may be relevant in this assessment (not exhaustive).

- A 'yes' to the following questions may suggest that the non-lease component is associated with the lease.
  - Must non-lease goods purchased in a lease contract be used with or consumed by the underlying asset?
  - Must services purchased in a lease contract be performed on or use the leased asset?

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- In contrast, a 'yes' to the following questions may suggest that the non-lease component is not associated with the lease.
  - Could the lessee use the non-lease goods with a different asset – e.g. use purchased supplies with an owned asset rather than the asset leased from the lessor?
  - Could the lessee direct the lessor to perform the contracted services on an asset other than the asset leased from the lessor – e.g. direct the lessor to perform management services for one of the lessee's owned properties instead of the asset leased from the lessor?

This guidance is largely reproduced from Question 4.4.05 in the Handbook. Example 4.4.05 in the Handbook illustrates this guidance.

Question 2.5.10

Lessor practical expedient – operating lease classification criterion

Is a lessor required to undertake a quantitative analysis to prove that the lease element of a combined component would be classified as an operating lease if accounted for separately?

Interpretive response: No. The Board explained in the basis for conclusions to ASU 2018-11 that it does not intend to require lessors to quantitatively prove the lease passes the present value classification tests by allocating the combined payments to the lease and non-lease components. Rather, lessors would meet the practical expedient's operating lease classification criterion if it is reasonably expected, based on an appropriate *qualitative* evaluation, that the lease component would be classified as an operating lease if accounted for separately. [ASU 2016-02.BC120, ASU 2018-11.BC30]

Judgment may be required to determine what constitutes an 'appropriate qualitative evaluation'. The following paragraphs address two acceptable approaches we believe lessors could use to address the practical expedient's operating lease classification criterion. There may be other acceptable approaches.

In many cases, and assuming the lease does not meet any of the other criteria to be classified as a sales-type or direct financing lease, we believe lessors will be able to conclude that the lease would be classified as an operating lease by performing the present value tests using the combined lease and non-lease payments. If the combined payments do not result in sales-type or direct financing classification of the lease under the present value tests, then neither would any other possible allocation of the payments to the lease. For example, this may be the case for some real estate leases where the non-lease CAM component is relatively insignificant in comparison to the lease.

Alternatively, a lessor may be able to consider an allocation approach that would not be permissible if allocation to the components was required. For example, even if the lessor is not permitted to use a residual approach to estimate the

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stand-alone selling price of the lease or non-lease component (see Question 4.4.55 in the Handbook), in some cases the results of a residual approach may provide a relevant data point when assessing the operating lease classification criterion of the practical expedient. This may occur if, for example, the residual allocation is to the non-lease component, resulting in a greater allocation to the lease component than would result from using a non-residual allocation technique.

Question 4.4.12 in the Handbook provides additional background about the operating lease classification criterion.

Question 2.5.20

Lessor practical expedient – same pattern of transfer requirement

When does a non-lease component meet the same pattern of transfer criterion to qualify for combination with a lease component?

Interpretive response: In general, to meet the same pattern of transfer requirement, a non-lease component (e.g. CAM) must: [606-10-25-15, 25-27, 25-31 – 25-37, 55-17, 55-20]

- meet one of the Topic 606 criteria to be satisfied over time; and
- have a straight-line pattern of transfer to the lessee.

Question 4.4.13 in the Handbook provides additional guidance about evaluating the same pattern of transfer criterion.

Question 2.5.30

Lessor practical expedient – evaluating predominance

Is a lessor required to evaluate predominance of the lease component or non-lease component(s) quantitatively?

Interpretive response: No. The basis for conclusions to ASU 2018-11 states explicitly that, "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." Therefore, we believe it would be inconsistent with the Board's view to require a quantitative predominance evaluation. [ASU 2018-11.BC35]

Further, when considering predominance, the lessor considers whether the lessee would be reasonably expected to ascribe more value to the non-lease component(s) than to the lease component. [842-10-15-42B]

We believe this assessment is inherently a qualitative, rather than quantitative, evaluation that would necessarily consider generally qualitative information about how the lessor markets and promotes itself to customers. Particularly

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relevant, given that each combined component is subject to its own predominance evaluation, will likely be how the lessor promoted itself and the relevant lease and non-lease components in the context of the present contract – e.g. its response to the relevant customer request for proposal.

Notwithstanding the above, there may be available and relevant quantitative information other than a theoretical allocation to the components that should be considered as part of the analysis. One example could be quantitative information about the lessor's costs to fulfill the components. Assuming the lessor expects that the customer has at least some understanding of the lessor's relative efforts and costs to fulfill the components, that cost information may be relevant when evaluating the relative value a customer would be expected to ascribe to the lease and non-lease component(s).

Question 4.4.15 and paragraphs 4.4.62–4.4.63 in the Handbook provide additional guidance about evaluating predominance.

Question 2.5.35

Lessor practical expedient – lease and services are not co-terminus

Can the lessor apply the non-separation practical expedient when the lease and non-lease components are not co-terminus?

Interpretive response: No. For the lessor non-separation practical expedient to apply, we believe the lease and the non-lease component must be satisfied over the same period of time – i.e. the lease term and the term of the non-lease component must be co-terminus.

We believe an exception arises if the lessee has the option to renew a shorter term non-lease component for the full duration of the 'lease term' or longer, and: [606-10-55-42 – 55-43, 55-45]

- the option provides the lessee with a material right;
- the lessor has elected and is permitted to apply the practical expedient in paragraph 606-10-55-45 to account for the material right; and
- the lessor expects, in accordance with paragraph 606-10-55-45, to provide the non-lease service for a period equal to (neither shorter than, nor exceeding) the lease term.

Question 4.4.16 in the Handbook provides a background example and additional guidance.

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Question 2.5.40

Stand-alone selling price for CAM provided by the lessor at a loss

Assuming the non-separation practical expedient is not being applied, should a lessor providing CAM at a loss include a profit margin when determining the stand-alone selling price for CAM?

Interpretive response: Yes. While CAM may be provided at a loss by real estate lessors, the stand-alone selling price (i.e. 'the price at which an entity would sell a promised good or service separately to a customer') of CAM would generally not be such that it would result in a loss.

Even if the loss-based CAM pricing is stipulated in the contract, and even if other lessors similarly price their CAM in bundled lease arrangements, the stand-alone selling price for CAM based on the guidance in Topic 606 would differ from that contractually stated amount.

Question 4.4.70 in the Handbook provides additional guidance.

Question 2.5.50

Variable payments that do not depend on an index or rate and the consideration in the contract

Do variable payments that do not depend on an index or rate change the consideration in the contract when they become fixed?

Interpretive response: For lessors, variable payments that do not depend on an index or rate and specifically relate to a non-lease component such as CAM change (i.e. become part of) the consideration in the contract when the changes in facts and circumstances on which the variable payment is based occur.

In contrast, variable payments that do *not* specifically relate to a non-lease component (e.g. percentage rent or property tax payments in a net lease) never become part of the consideration in the contract (absent a contract modification not accounted for as a separate contract) – even when the changes in facts and circumstances on which the variable payment is based occur.

Question 4.5.10 in the Handbook provides additional guidance.

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3. Lessor accounting

Detailed contents

New item added in this edition: **

3.1 Lease classification

Questions

3.1.05 Determining the lease commencement date

3.1.10 Facts and circumstances and additional factors to consider when evaluating 'reasonably certain'

3.1.20 Effect of termination notice clauses on the non-cancellable period

3.1.25 Contingent termination provisions

3.1.30 Lessee and lessor extend the lease even though both have the right to terminate without penalty

3.1.40 Lease term when the non-cancellable lease period is not fixed

3.1.50 Lease term when the period of use includes non-consecutive periods of time

3.1.60 Economic life vs remaining useful life of an asset

3.1.70 Effect of lease payments made before commencement date on lease classification

3.1.80 Deposits

3.1.90 Changes in a reference index or rate

3.1.100 Variable lease payments based on fair market rent

3.1.105 Variable lease payments that depend on the fair value of the underlying asset

3.1.110 Highly certain payments based on performance or usage

3.1.120 Determining the accounting owner of leasehold improvements

3.1.121 Accounting owner of structural leasehold improvements

3.1.125 Lessee payments for leasehold improvements owned by the lessor

3.1.130 Payments to existing lessee to induce early termination

3.1.140 Significant variable lease payments that result in a negative implicit rate

3.1.150 Determining the discount rate for a portfolio of leases

3.1.160 Fair value practicability exception – undue cost and effort

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3.2 Lessor accounting

3.2.10 Overview

3.2.20 Collectibility reassessment

Questions

3.2.01 Effect of a government grant toward the cost of an underlying asset on the asset's fair value

3.2.02 Fair value in a build-to-suit lease

3.2.10 Estimated residual value of land in a long-term sales-type or direct financing lease

3.2.20 Assessing whether a tax is a lessee or lessor cost

3.2.25 Lease incentives paid before lease commencement

3.2.26 Contingent lease incentives

3.2.30 Lessor reassessment of key lease estimates and judgments

3.2.40 Assessing the net investment in the lease for impairment

3.2.45 Sale of future operating lease payments that do not meet the definition of a receivable

3.2.50 Uneven lease payments intended to compensate for expected changes in market rent

3.2.52 Operating lease income in lease with non-consecutive period of use

3.2.53 Single lease cost attribution – operating lease with non-consecutive period of use that is variable at lease commencement

3.2.54 Curtailment of the lessee’s right to use the underlying asset

3.2.55 Lessor accounting for reimbursements of capital replacements and repairs in an operating lease

3.2.60 Impact of collectibility reassessment on lessors

3.2.70 Collectibility of operating lease receivables – lease-by-lease basis

3.2.80 Collectibility of operating lease receivables – ongoing assessment

3.2.90 Collectibility of operating lease receivables – leases subject to the collectibility constraint

3.2.100 Collectibility of operating lease receivables – leases not subject to constraint

3.2.110 Collectibility of operating lease receivables – accounting for a general reserve

3.2.120 Collectibility of operating lease receivables – impact of constraint on general reserve

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3.3 Lease modifications

Questions

3.3.05 Contract modifications not in writing

3.3.05A Contract changes only affecting variable or contingent payments **

3.3.06 Rent concessions

3.3.07 Lessee short payment of rent

3.3.08 Lessor consideration of a lessee's notice to exercise its purchase option

3.3.10 Co-tenancy clauses

3.3.20 Modifications that add a right(s) of use *and* make other changes

3.3.30 Lessee exercise of options other than to extend the lease or purchase the underlying asset

3.4 Financial statement presentation

Question

3.4.10 Separate income statement presentation of tenant reimbursements

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3.1 Lease classification

A lessor determines lease classification for each separate lease component at the lease commencement date. The lease commencement is the date on which a lessor makes an underlying asset available for use by a lessee. [842-10-25-1; Master Glossary]

Lease classification is only reassessed if the lease is modified and the modification is not accounted for as a separate contract. [842-10-25-1]

Before adopting ASU 2021-05, the lease classification tests can be grouped into two parts (Part A and Part B). [842-10-25-2 – 25-3]

After adopting ASU 2021-05 only, a lessor applies the new 'Step 0' test before it proceeds to the Part A and B tests.

Step 0

A lessor is required to classify a lease as operating if:

— the payments for the lease are partially or entirely variable; and
— sales-type or direct financing classification would result in a commencement date ('day 1') loss.

If only one or neither of these criteria are met, the lessor proceeds to the Part A tests.

Part A

These tests determine whether a lease is a sales-type lease and are the same as the classification tests for lessees. The outcome of these tests is either (1) the lease is a sales-type lease, or (2) further testing is required (Part B) to classify the lease.

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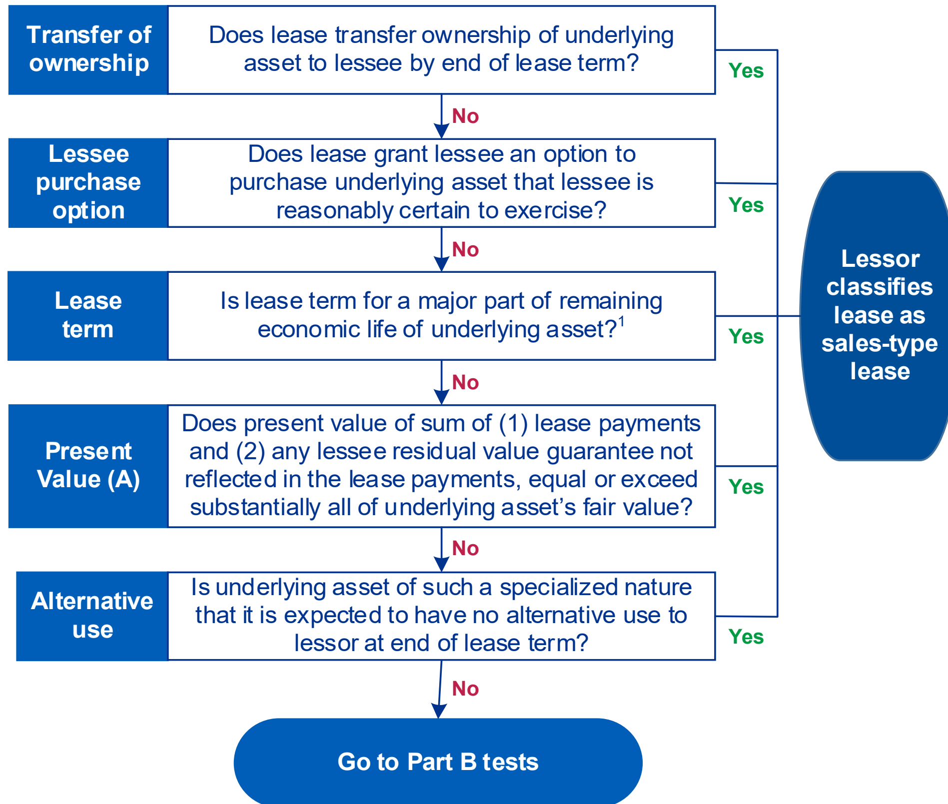

Transfer of ownership test

The transfer of ownership test is met in leases that require: [842-10-55-4 – 55-5]

- the lessor to release the underlying asset from the lease and to transfer ownership to the lessee upon the lessee's performance in accordance with the terms of the lease; or
- the lessee to pay a nominal amount in connection with ownership transfer of the underlying asset – e.g. a minimum statutory fee to transfer ownership.

Lessee purchase option test

The lessee purchase option test is met if it is reasonably certain that the lessee will exercise the option. 'Reasonably certain' is a high threshold of probability, and the Board intended the parties to account for lessee options only when the lessee has a compelling economic reason to exercise the option.

Lease term test

The lease term comprises the non-cancellable period (including free-rent periods) and periods for which the lessee has the option to extend (not terminate) if the lessee is reasonably certain to extend (not terminate) and periods for which the lessor has the option to extend (or terminate).

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The lease term excludes periods after which both parties' unilateral termination rights (with no more than an insignificant penalty) are exercisable because neither party has enforceable rights or obligations.

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 in determining the lease term. [842-10-55-24]

If only a *lessor* has the right to terminate a lease or controls the lessee's ability to exercise an option to terminate the lease, the lease term should assume that the lease will not be terminated. [842-10-55-24]

When evaluating the lease term test, an entity may use the following thresholds [842-10-55-2]

— 75 percent or more of the remaining economic life may be considered a major part of the remaining economic life of that underlying asset.

— A lease that commences with 25 percent or less of the underlying asset's total economic life remaining may be considered to commence at or near the end of the asset's economic life.

The economic life of an asset is either the period over which the asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users.

Part A present value test

When performing the present value test, the lessor determines the present value of the lease payments and residual value guarantees using the rate implicit in the lease.

At lease commencement, the lease payments consist of: [842-10-30-5]

— fixed payments;

— variable lease payments that depend on an index or rate (derived using the index or rate at lease commencement);

— adjustments to fixed payments (in-substance fixed payments – added; lease incentives paid/payable by the lessor to the lessee – subtracted);

— the exercise price of a lessee option to purchase the underlying asset that the lessee is reasonably certain to exercise;

— penalties for terminating the lease if the lease term reflects the lessee exercising a termination option; and

— payments by the lessee to the owners of a special purpose entity for structuring the transaction.

Lease payments do *not* include: [842-10-30-6]

— variable lease payments other than those that depend on an index or rate;
— any guarantee by the lessee of the lessor's debt; or
— amounts allocated to non-lease components.

If the contract includes lease and non-lease components (see chapter 2 in the Handbook), the lease payments are typically an allocated amount rather than an

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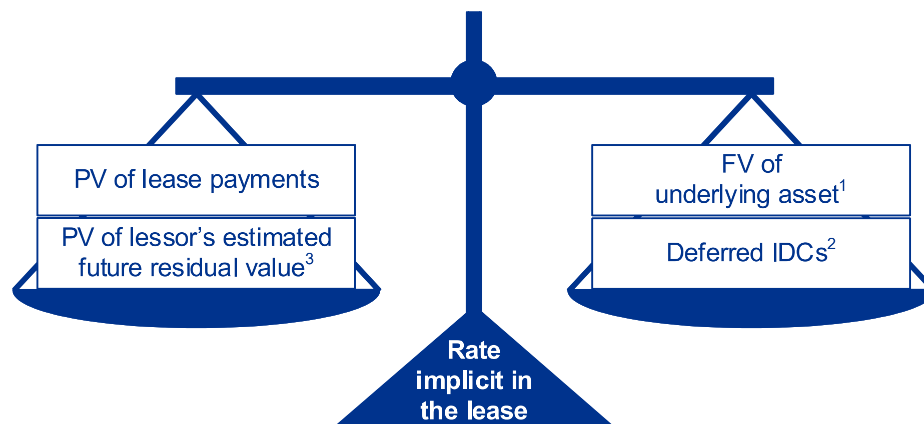
amount stated in the contract. This will be the case unless the lease and the non-lease component (e.g. CAM) are priced separately in the contract at their stand-alone selling prices.

The rate implicit in the lease is 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. However, if the rate determined in accordance with this equation is less than zero, a rate of zero should be used. The rate implicit in the lease cannot be less than zero. [842 Glossary]



Notes:

1. In determining the rate implicit in the lease, the fair value of the underlying asset is reduced by the amount of any investment tax credit related to the underlying asset that is retained and expected to be realized by the lessor. [842 Glossary]
2. Initial direct costs are not deferred (i.e. they are expensed at lease commencement) if the lease is a sales-type lease and the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3.1 of the Handbook). [842-30-25-1(c)]
3. If a lessee uses the rate implicit in the lease, the estimated future residual value excludes amounts probable of being owed by the lessee to satisfy a residual value guarantee, which are included in the lease payments (see section 5.4.6 of the Handbook).

When calculating the rate implicit in the lease, a lessor assumes that no initial direct costs will be deferred, if and only if, at the commencement date the fair value of the underlying asset is different from its carrying amount. [842-10-25-4]

The lessor may use a threshold of 90 percent or more when determining what constitutes substantially all of the fair value of the underlying asset. [842-10-55-2(c)]

Alternative use test

In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, an entity considers the effect of contractual restrictions and practical limitations on the lessor's ability to readily direct the underlying asset for another use. [842-10-55-7]

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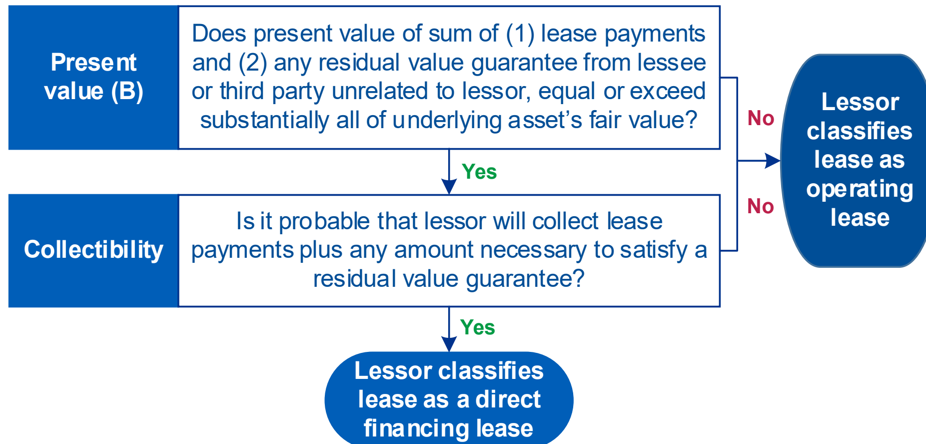
Part B

When a lease is not a sales-type lease, these tests determine whether the lease is an operating lease or a direct financing lease.



Part B tests

The Part B classification tests focus on whether substantially all of the lessor's risk in the lease is credit risk. When the lessor effectively converts its risk in the nonfinancial residual asset to credit risk (e.g. through a residual value guarantee provided by an unrelated third party) and collectibility of the lease payments (plus any amount necessary to satisfy the residual value guarantee(s) provided to the lessor) is probable, the lease is a direct financing lease. Otherwise, it is an operating lease.

The primary difference between the present value test in Part A and the present value test in Part B is the inclusion in Part B of any residual value guarantee provided by a third party unrelated to the lessee or the lessor (in addition to any residual value guarantee provided by the lessee in the Part A present value test). Consistent with the present value test in Part A, a lessor may use the 90 percent threshold.

Additionally, in determining the rate implicit in the lease for purposes of the Part B present value test, the lessor always assumes any initial direct costs will be deferred when calculating the rate implicit in the lease; this is regardless of whether the fair value of the underlying asset is different from its carrying amount.

Chapters 6 and 7 in the Handbook address lease classification. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Transfer of ownership test	Paragraphs 6.2.60–6.2.70
Lessee purchase option test	Paragraph 6.2.80
Lease term test	Paragraphs 5.3.10–5.3.100, 6.2.90–6.2.100 Question 6.2.10

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Economic life of the underlying asset	Paragraphs 5.7.10–5.7.70
Present value test	Paragraphs 6.2.110–6.2.136 Questions 6.2.19-6.2.21
Lease payments	Paragraphs 5.4.10–5.4.90
Costs to dismantle and remove the underlying asset imposed by the lease agreement	Question 5.4.05
Payments made by the lessee to extend the lease	Question 5.4.10
Variable lease payments	Paragraph 5.4.100–5.4.150
In-substance fixed leased lease payments	Paragraphs 5.4.230–5.4.260
Lease incentives	Paragraphs 5.4.290–5.4.330
Purchase options	Paragraphs 5.4.340–5.4.360 Example 5.4.100
Termination penalties	Paragraph 5.4.370 Example 5.4.110
Rate implicit in the lease	Paragraphs 5.6.40–5.6.60
Alternative use test	Paragraphs 6.2.150–6.2.170 Question 6.2.30
Related party leases	Paragraph 6.2.210 Question 6.2.50#
Environmental indemnifications and lease classification	Paragraph 6.2.250
Part B classification tests	Paragraphs 7.2.60–7.2.90
Seller guarantee of resale amount – transfer of control	Question 7.2.10
Lease classification in a lease resulting from a repurchase agreement	Question 7.2.20
Residual value guarantees	Section 5.4.6
Comparison to legacy GAAP	Paragraphs 7.2.100–7.2.110

Question 3.1.05
Determining the lease commencement date

Can the lease 'commence' before the lessee begins operations?

Interpretive response: Yes. The lease commencement date is defined as the date on which a lessor makes the underlying asset available for use by a lessee. [Master Glossary]

A lessee may take possession of or be given control over the use of an underlying asset – i.e. the underlying asset may be made available for use by the lessee – before: [842-10-55-19]

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— the lessee begins operations – e.g. before the lessee begins selling from a leased retail space;
— lease payments are required to be made under the contract; or
— a stated commencement date in the contract.

Because the lease commencement date is the date when the lessee obtains control over the use of the underlying asset and lease income recognition begins, its proper identification is important. Identifying the nature of the underlying asset is key. For example, in some situations, the underlying asset may include lessor-owned property improvements, and commencement will occur only once those improvements are complete. In other cases, the underlying asset is an unfinished space or building and lease commencement will occur when the lessee obtains control over the use of the space or building for construction or installation of its leasehold improvements. Examples 5.1.10 and 5.1.15 in the Handbook illustrate in several scenarios how to determine the lease commencement date when improvements are being constructed.

Question 3.1.10

Facts and circumstances and additional factors to consider when evaluating 'reasonably certain'

Can an entity reach different conclusions about whether exercise is reasonably certain for two options with very similar terms that relate to different leases?

Interpretive response: Yes. The particular facts and circumstances of a lease can significantly affect an entity's assessment of a lessee option such that an entity might reach different conclusions about whether exercise is reasonably certain for two options with seemingly very similar terms (e.g. the same strike price and the same expected fair value of the underlying asset) based on different underlying facts and circumstances.

Additional guidance about evaluating the reasonably certain threshold is provided in the Handbook as follows.

Additional guidance and facts and circumstances to consider	Paragraphs 5.2.10–5.2.60 Question 5.2.10
Assessing renewal options in warehouse leases	Example 5.2.10
Concluding on the lease term for renewable warehouse leases	Example 5.3.10

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Question 3.1.20

Effect of termination notice clauses on the non-cancellable period

Does a clause in a lease that requires a termination notice before a lessee or lessor can formally terminate a lease contract affect the non-cancellable period of a lease?

Interpretive response: Yes. When either the lessee or lessor has the right to terminate a lease at any time on giving notice to the other party, the non-cancellable period of the lease includes the 'notice' period.

For example, a lease agreement may grant each party the unilateral right to terminate the lease, for any reason and without penalty (see paragraphs 5.3.80–90), on giving 90 days' notice to the other party. This means that at any point in time before such notice is given by either party, enforceable rights and obligations for both parties exist for 90 days. Therefore, at lease commencement, and until either party gives notice of its intent to terminate the lease, the non-cancellable period of the lease is 90 days.

This guidance is reproduced from Question 5.3.20 in the Handbook. The following additional guidance about evaluating termination notices is provided in the Handbook.

Legal evaluation of the non-cancellable period	Question 5.3.10
Extension or renewal options controlled by an unrelated third party	Question 5.3.30
Lease term when lessee and lessor both have termination rights (and the lessor's right gives rise to a more-than-insignificant penalty)	Question 5.3.40
Lease term when lessee and lessor both have termination rights (and the lessee's right gives rise to a more-than-insignificant penalty)	Question 5.3.50 Example 5.3.20
Lessee partial termination rights	Example 5.3.25

Question 3.1.25

Contingent termination provisions

Does a contingent termination provision in a lease affect the non-cancellable period of a lease?

Background: A lessee may have the right to terminate the lease before the end of the stated non-cancellable term in the contract only if a future event occurs or circumstance arises. For example, despite a stated non-cancellable lease period of 10 years, the lessee may have the contingent right to terminate the

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lease on or after an earlier date if a designated event occurs (or does not occur) or condition exists.

For example, a lessee has the right to terminate a retail space lease with a 10-year stated non-cancellable term after 5 years of that term if its average annual sales from the retail space over that 5-year period are less than a specified amount. This provision gives the lessee the ability to early terminate a lease that is not providing its desired return.

Interpretive response: Yes. Considering the retail space example in the background, even though the lease contract has a *stated* non-cancellable lease term of 10 years, we believe the non-cancellable term of the lease is only 5 years because of the contingent termination provision.

We believe an entity (lessee or lessor) assesses a contingent termination provision the same way it assesses a non-contingent termination provision. That is, the entity includes the period(s) after the contingent termination option in the 'lease term' only if the lessee is reasonably certain *not* to exercise the option.

When assessing whether the lessee is reasonably certain not to exercise the contingent termination option, we believe an entity considers the probability of the contingency occurring or arising and the likelihood the lessee will choose not to terminate the lease even if the contingency is triggered.

The following table summarizes our view on analyzing a contingent termination provision.

Likelihood of contingency occurring or arising	Other economic factors considered?	Reasonably certain conclusion
Remote[1]	N/A. It is reasonably certain the termination option will not become exercisable, so no other economic factors need be considered.	Lessee is **reasonably certain to *not* terminate**.
More than remote	Yes. Consider likelihood of termination option exercise based on the same factors that would be considered if the termination option were *not* contingent (see paragraph 5.2.60 in the Handbook).	**It depends. Consider likelihood of triggering the option together with other relevant economic factors.**

Note:

1. Remote means 'the chance of the future event or events occurring is slight'. [842 Glossary]

Question 5.3.25 in the Handbook provides additional background and guidance.

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Question 3.1.30

Lessee and lessor extend the lease even though both have the right to terminate without penalty

How should an entity account for a lease extension triggered by both parties *not* exercising their unilateral termination rights?

Interpretive response: We believe a modification occurs if neither party exercises its termination right, creating new enforceable rights and obligations that now exist until the next date at which both parties can terminate the lease without incurring a more-than-insignificant penalty.

The contract modification that occurs is a lease term extension, no different from two parties having a non-cancellable one-year lease and executing an amendment to that lease extending the non-cancellable period by an additional year.

Both the lessee and the lessor will account for the lease term extension modification in the same manner as they would any other lease term extension modification.

Question 5.3.60 in the Handbook provides additional background and guidance.

Question 3.1.40

Lease term when the non-cancellable lease period is not fixed

Should an entity reassess the lease term when the non-cancellable period of the lease is not fixed or determinable at lease commencement?

Interpretive response: Yes, both the lessee and the lessor should reassess the lease term when the non-cancellable period of the lease becomes fixed or determinable.

We are aware of certain lease arrangements for which the non-cancellable period of the lease is not fixed or determinable at lease commencement. For example:

- two parties may enter into an agreement whereby the lessor will lease multiple underlying assets to the lessee, but the non-cancellable period for all of the underlying assets does not become fixed until the last one is deployed and that final date of deployment is unknown when earlier underlying assets are made available for the lessee's use; or
- the non-cancellable period of the lease may be for the duration of a project whose timeline is uncertain at the commencement date.

Question 5.3.80 in the Handbook provides additional guidance.

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Question 3.1.50

Lease term when the period of use includes non-consecutive periods of time

What is the 'lease term' when the period of use comprises non-consecutive periods of time?

Interpretive response: The 'lease term' is the sum of the non-cancellable, non-consecutive periods of time plus any additional non-consecutive periods of time covered by renewal options (1) that the lessee is reasonably certain to exercise or (2) that are controlled by the lessor.

Question 5.3.90 in the Handbook provides additional guidance and Example 5.3.40 illustrates this guidance with a seasonal retail lease and a stadium lease.

Question 3.1.60

Economic life vs remaining useful life of an asset

Can the economic life of an asset differ from its useful life?

Interpretive response: Yes. The economic life of an asset is either the period over which the asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users. [842 Glossary]

In contrast to the definition of economic life, the useful life of an asset (i.e. the period over which an entity will depreciate the asset) is the period over which the asset is expected to contribute directly or indirectly to future cash flows. The useful life of an asset can differ depending on the asset's intended use by its current owner.

In the Handbook, paragraphs 5.7.10–5.7.70 provide additional discussion about economic life, and Example 5.7.10 illustrates how the economic life of a building may differ from its useful life.

Question 3.1.70

Effect of lease payments made before commencement date on lease classification

How are payments made by the lessee to the lessor before the commencement date for the right to use the underlying asset considered when determining lease classification?

Interpretive response: Payments (or potentially only a portion of such payments if the contract includes non-lease components) made by a lessee to

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the lessor before the commencement date are 'lease payments' when they relate to the right to use the underlying asset.

In some cases, the prepayments may be made significantly before the lease commencement date (e.g. the underlying asset is under construction). Under Topic 840, payments made before lease commencement were accreted to their future value at the commencement date when performing the 'present value' lease classification test. [840-10-25-6(d)]

Topic 842 does not include explicit guidance like that in paragraph 840-10-15-6(d). However, consistent with that Topic 840 requirement, we believe such amounts should be included in the lease payments used to perform the present value lease classification test (see section 3.1) at their future value as of the commencement date of the lease, using the same interest rate used to discount the payments to be made after lease commencement (i.e. the 'discount rate for the lease' – see section 5.6 in the Handbook), to give effect to the time value of money.

Accreting lease prepayments to their future value for purposes of lease classification does not extend to:

- recognizing interest income during the period before lease commencement; or
- calculating the rate implicit in the lease; the calculation (see section 3.1) includes the amount of the lease prepayment – not its accreted future value used in the present value lease classification test.

Question 3.1.80
Deposits

Are deposits paid by a lessee to a lessor at or before the commencement date part of the 'consideration in the contract'?

Interpretive response: It depends. If a deposit is nonrefundable, it is a fixed payment no different from any other fixed payments made before the commencement date. That is, it is part of the consideration in the contract and allocated to the lease and non-lease components in the same manner as the rest of the consideration in the contract.

A deposit is not part of the consideration in the contract when it is refundable. Refundable deposits, in addition to any interest earned by the lessor on the refundable deposit, are variable payments that do not depend on an index or rate.

Question 5.4.40 in the Handbook provides additional guidance.

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Question 3.1.90

Changes in a reference index or rate

Does a change in the reference index or rate upon which variable lease payments depend trigger a remeasurement of the lease payments?

Interpretive response: No. A change in a reference index or rate does not trigger a remeasurement of the lease payments, including variable lease payments that depend on an index or rate.

Example 5.4.20 in the Handbook illustrates the accounting for variable lease payments that change based on CPI-U.

Question 3.1.100

Variable lease payments based on fair market rent

Are lease payments that adjust to fair market rent during the lease term considered to be based on an index or rate?

Interpretive response: Yes. While Topic 842 does not specifically identify fair market rent as an index, we believe it meets the definition of an index.

Payments equal to fair market rent at lease commencement are included in the lease payments and are remeasured under the same circumstances and in the same manner as other variable lease payments that depend on an index or rate.

Question 5.4.60 in the Handbook provides additional guidance and Example 5.4.30 illustrates the accounting.

Question 3.1.105

Variable lease payments that depend on the fair value of the underlying asset

Are lease payments that adjust based on the fair value of the underlying asset(s) during the lease term considered variable lease payments that depend on an index or rate?

Background: Some leases stipulate that the lease payments will be adjusted based on the fair value of the underlying asset(s) after lease commencement. For example, a lease may include fixed payments for Years 1–5 of a 10-year term, but specify that the lease payments for Years 6–10 will equal a percentage of the fair value of the underlying asset.

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Interpretive response: In scenarios similar to the background example, we believe lease payments that adjust based on the fair value of the underlying asset(s) should generally be accounted for as variable lease payments that depend on an index. This is for reasons substantially consistent with those in Question 3.1.100 on lease payments that adjust based on fair market rent.

— In that case, the payments that are based on the fair value of the underlying asset are included in the lease payments at lease commencement based on the commencement date fair value of the underlying asset(s); and
— remeasured under the same circumstances and in the same manner as other variable lease payments that depend on an index or rate (see paragraphs 5.4.130 – 5.4.140 in the Handbook).

Question 5.4.65 in the Handbook provides additional guidance.

Question 3.1.110

Highly certain payments based on performance or usage

Should variable lease payments that are highly certain to occur based on performance or usage be treated as in-substance fixed lease payments?

Background: In-substance fixed payments include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select under the lease (e.g. due to optional features within the lease). In-substance fixed payments for a lessee or a lessor might include the following, for example: [842-10-55-31]

— payments that result from clauses that do not have economic substance; or
— the lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

Interpretive response: No. We believe that even variable lease payments that are highly (or even virtually) certain to occur are not in-substance fixed lease payments if the payments are based on performance or usage of the underlying asset.

Additional guidance about in-substance fixed lease payments is provided in the Handbook as follows.

Concept of in-substance fixed lease payments	Paragraphs 5.4.230–5.4.280
Highly certain payments based on performance or usage (additional guidance)	Question 5.4.70
Identifying in-substance fixed lease payments in a land and building lease with two possible sets of lease payments	Example 5.4.40
Accounting for a warehouse lease that includes variable lease payments without economic substance	Example 5.4.50

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Identifying lease payments in a retail-space lease with payments based on performance	Example 5.4.60
Protective provisions in lease payments	Example 5.4.70

Question 3.1.120

Determining the accounting owner of leasehold improvements

Does the determination of the accounting owner of leasehold improvements affect the accounting for a lease?

Background: The lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both: [842-10-55-30]

- payments made to or on behalf of the lessee; and
- losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party.

Interpretive response: Yes, in multiple respects.

Effect on the consideration in the contract

All payments made by a lessor to a lessee are an incentive, reducing the consideration in the contract, unless the payments are for a distinct good or service provided by the lessee to the lessor (e.g. for construction of, or managing the construction of, the lessor's assets). In addition, even if the lessee provides a distinct good or service to the lessor, any amount of the lessor's payments in excess of the fair value of the distinct good or service is an incentive. [842-10-15-35(a), 606-10-32-25 – 32-26]

Therefore, lessor payments to the lessee for leasehold improvements are incentives, reducing the consideration in the contract when the leasehold improvements are assets of the lessee for accounting purposes – i.e. they are not a payment for a distinct good of the lessor in that case.

Effect on lease commencement

As outlined in section 5.1 of the Handbook (in particular, see Example 5.1.10), the accounting owner of leasehold improvements may determine the lease commencement date.

Paragraph 5.1.20 in the Handbook discusses the possible accounting effects of an improperly determined lease commencement date.

Determining the accounting owner

In the Handbook, paragraphs 5.4.290–5.4.330 provide additional discussion about lease incentives, and Question 5.4.80 provides additional guidance about leasehold improvements, including factors to consider when determining whether the lessee or the lessor is the accounting owner of specified leasehold improvements.

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Question 3.1.121

Accounting owner of structural leasehold improvements

Is the lessor automatically the accounting owner of structural leasehold improvements?

Background: Structural leasehold improvements include (not exhaustive): HVAC systems, electrical or plumbing infrastructure and elevators that are typically integrated into a leased building (or part of a building). Because of their integration into the lessor's owned building, some entities have assumed that those improvements must be lessor-owned for accounting purposes.

Interpretive response: No. The lessor is not automatically the accounting owner of structural leasehold improvements. The same principle and considerations that apply to other leasehold improvements apply to structural leasehold improvements (see Question 3.1.120). Depending on the facts and circumstances, the accounting owner of structural leasehold improvements may be the lessee or the lessor.

The guidance is reproduced from Question 5.4.81 in the Handbook. Example 5.4.85 in the Handbook illustrates determining the accounting owner of structural leasehold improvements.

Question 3.1.125

Lessee payments for leasehold improvements owned by the lessor

How should an entity account for payments by the lessee for lessor-owned leasehold improvements?

Interpretive response: When the lessor is determined to be the accounting owner of improvements to the underlying asset (see Question 3.1.120 in this publication), lessee payments for those improvements are either:

- fixed payments, and therefore included in the 'consideration in the contract'; or
- variable payments excluded from the consideration in the contract.

Making a payment for a lessor-owned asset (i.e. the improvements) is substantively no different from making a cash payment to the lessor. Whether the payment is a fixed payment or a variable payment depends on the facts and circumstances.

Fixed payment

If the contract stipulates a fixed amount the lessee must pay for (or toward) the lessor-owned improvement(s), that amount is included in the consideration in the contract at lease commencement. All or a portion of the amount (i.e. if there are non-lease components not combined with the lease component) will be a 'lease payment'; the exception being if the entity is the lessor, and it is accounting for the lease as part of a single Topic 606 performance obligation.

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Variable payment

If the contract requires the lessee to pay for a lessor-owned improvement, but the amount is unknown at lease commencement, such payments are variable payments that do not depend on an index or rate. Therefore, they are not included in the consideration in the contract at lease commencement.

The following occurs once the variable payment amount becomes fixed.

- The **lessee** remeasures the consideration in the contract for the resolution of that contingency (see paragraphs 6.6.90 and 6.6.140 in the Handbook).
- In addition to recognizing its owned asset improvements, the **lessor** recognizes (see section 3.2 in this publication):
  - the amount allocable to the lease component as variable lease revenue (unless the amount the lessee will pay is a reimbursement to the lessor of the nature described in Question 3.2.55 in this publication); and
  - any amount allocable to non-lease components when the requirements of the applicable Topic (e.g. Topic 606) are met.

Contract silent at lease commencement

The contract may be silent with respect to lessor-owned improvements, and therefore there is no accounting at lease commencement. If lessor-owned improvements are subsequently constructed or installed, and the lessee is required to pay for them (which includes costs incurred by the lessee – e.g. if the lessee uses its own personnel to construct or install the improvements), we believe that is a lease modification. This new requirement changes the consideration in the contract, which now includes the amounts paid (or required to be paid) for the lessor-owned improvements.

See section 3.3 of this publication for guidance on lessor accounting for lease modifications.

This guidance is reproduced from Question 5.2.85 in the Handbook.

Question 3.1.130

Payments to existing lessee to induce early termination

Are payments made by a lessor to a lessee to induce early termination of the lease agreement an initial direct cost?

Background: Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not been executed). [842 Glossary]

The following are examples of costs that would typically be included in, or excluded from, initial direct costs. [842-10-30-9 – 30-10, ASU 2016-02.BC221 – BC222, BC304]

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Typical initial direct costs	
Include	**Exclude**
– Commissions – Payments made to an existing tenant to incentivize that tenant to terminate the lease	– Legal fees – Costs of evaluating the prospective lessee's financial condition – Costs of negotiating lease terms and conditions – General overheads

Interpretive response: In certain situations, yes. A payment to induce early termination is an example of a potential initial direct cost. However, initial direct costs are only those that are incurred as a result of obtaining a lease. [842-10-30-9]

Therefore, in general, we believe these payments are initial direct costs if incurred in connection with a replacement lease. In contrast, if a lessor offers to make a payment to a lessee to early terminate a lease solely because the current lease is at a below-market rate (i.e. the lessor wants to terminate an out-of-the-money lease) and does not have an identified new lessee, the payment would generally not meet the definition of an initial direct cost.

Additional guidance about initial direct costs is provided in the Handbook as follows.

Topic	Reference
Concept of initial direct costs and comparison to ASC 840	Paragraphs 5.5.10–5.5.80
Additional guidance about payments to an existing lessee	Question 5.5.10
Sales taxes as initial direct costs	Question 5.5.30
How to account for employee costs, external legal fees, travel costs, commissions, and termination payments	Example 5.5.10
Allocating initial direct costs between lease and non-lease components	Example 5.5.20 Example 5.5.30 (illustrates a retail space lease with CAM)

Question 3.1.140

Significant variable lease payments that result in a negative implicit rate

How is the rate implicit in the lease determined when the lease includes significant variable lease payments?

Interpretive response: For leases with significant variable lease payments, the undiscounted sum of (1) the lease payments and (2) the estimated residual

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value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. This is because variable lease payments that do not depend on an index or a rate are excluded from the lease payments.

In the event the rate implicit in the lease would be negative in such a variable lease payment scenario (based on the calculation in the first sentence of the definition of 'rate implicit in the lease'), an implicit rate of zero should be used. [ASC 842 Glossary 'Rate Implicit in the Lease']

A lessor should not, in such cases, use another discount rate for the lease such as the lessee's incremental borrowing rate or a rate that estimates the variable payments.

This question is reproduced from Question 5.6.10 in the Handbook. Question 7.3.30 in the Handbook provides additional background and guidance when this scenario results in a negative implicit rate for the lessor (before and after adopting ASU 2021-05). Examples 7.3.30 and 7.3.31 in the Handbook illustrate the concept before and after adopting ASU 2021-05, respectively

Question 3.1.150

Determining the discount rate for a portfolio of leases

Can an entity determine a discount rate for a portfolio of leases?

Interpretive response: In some circumstances, yes. The Board concluded that the leases guidance in Topic 842 can be applied at a portfolio level, rather than on a lease-by-lease basis, by lessees and lessors in some circumstances.

The Basis for Conclusions to ASU 2016-02 and Example 2 in Subtopic 842-20 highlight that the Board expects that some lessees will be able to use a portfolio approach to determine the discount rate for their leases with similar characteristics. This is permitted if doing so would not materially affect the lessees' accounting for those leases to which a single discount rate is applied. In the Board's view, applying a portfolio approach to determine the discount rate alleviates some of the concerns that entities expressed about determining (and documenting the basis for) a separate incremental borrowing rate for every lease. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

From a practical standpoint, an entity may be able to document which discount rate to apply for certain portfolios of leases, considering characteristics such as lease term, lease currency and geographic location. It could then apply a discount rate to a portfolio of leases with similar characteristics. The entity would need to design controls around portfolio discount rates to ensure that such rates are applied only to leases with similar characteristics and that the rates are updated periodically based on changes in the interest rate environment and other relevant factors.

This guidance is reproduced from Question 5.6.40 in the Handbook.

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Question 3.1.160

Fair value practicability exception – undue cost and effort

What constitutes 'undue cost and effort' when considering availability of the fair value practicability exception?

Interpretive response: Consistent with our views on Topic 360 (property, plant and equipment), we believe the fair value of individual long-lived assets generally should be determinable either individually or in aggregate *without* undue cost and effort. Therefore, we would not expect this exception to apply to leases of entire underlying assets (e.g. machine, vehicle, building) or portions of entire underlying assets that are legally separable (e.g. condominiums), or groups thereof (e.g. a fleet of vehicles).

Determining the fair value of a portion of a larger asset (e.g. floor of a building, cell tower rung, satellite transponder, fiber-optic cable strand) will frequently be more complex than determining the fair value of an entire asset. However, that does not necessarily mean its fair value is not 'determinable without undue cost and effort'.

We believe the more material the effect of the fair value determination on the entity the more difficult it is to argue that the cost and effort to determine the fair value of the underlying asset, including obtaining an appraisal or a similar valuation, is 'undue'. We believe the fair value of an underlying asset should be determinable, without undue cost and effort, in most cases. Regardless of whether the underlying asset is an entire asset or a portion of a larger asset, an entity that believes the fair value practicability exception applies to its facts and circumstances should consult with its auditors and/or other accounting advisors.

Question 6.2.19 and an Observation at paragraphs 6.2.131-6.2.136 in the Handbook provide additional guidance.

3.2 Lessor accounting

3.2.10 Overview

A lessor classifies a lease as a (1) sales-type, (2) direct financing or (3) operating lease. The accounting model applied to each type of lease depends on the lease classification and is summarized in the following diagram.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	— Recognize net investment in the lease — Derecognize the underlying asset	— Selling profit (loss)[1] — Interest income over the lease term	Cash received from leases classified as operating cash flows[2]

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	Balance sheet	Income statement	Cash flow statement
Operating leases	Continue to recognize the underlying asset	Lease income generally on a straight-line basis over the lease term	Cash received from leases classified as operating cash flows

Notes:

1. Selling profit is recognized at lease commencement for sales-type leases and over the lease term for direct financing leases. Selling loss is recognized at lease commencement for both sales-type and direct financing leases.
2. Lessors that are depository or lending institutions in the scope of Topic 942 (depository and lending institutions) classify the principal portion of cash payments received from leases in sales-type or direct financing leases as investing cash flows; the interest portion is classified as operating cash flows. All other lessors classify all cash receipts from leases, regardless of lease classification, as operating cash flows.

Sales-type and direct financing leases

For sales-type and direct financing leases, a lessor recognizes a net investment in the lease on its balance sheet and derecognizes the underlying asset. [842-30-25-1, 25-7, 40-1]

For a sales-type lease, the lessor's net investment in the lease comprises a lease receivable and an unguaranteed residual asset. For a direct financing lease, the lessor's net investment in the lease also includes any selling profit on the lease, which is deferred and recognized over the lease term; it is not recognized at lease commencement as it is for a sales-type lease. [842-30-30-1; 842-30-25-8, 30-2]

For both sales-type and direct financing leases, any initial direct costs of the lessor that are deferred are automatically included in the net investment in the lease based on how the rate implicit in the lease is calculated. They are not deferred separately.

The selling profit or selling loss for a sales-type or direct financing lease is: [842 Glossary]

— the lower of: (1) the fair value of the underlying asset or (2) the sum of the lease receivable + any prepaid lease payments;
— minus the carrying amount of the underlying asset, net of any unguaranteed residual asset;
— minus any initial direct costs of the lessor that are deferred (i.e. capitalized).

For lessors that are *not* manufacturers or dealers the fair value of the underlying asset is its cost, reflecting volume or trade discounts. Cost includes acquisition costs such as those arising from sales taxes, shipping/delivery and installation. An exception arises if a significant period of time elapses between asset acquisition and lease commencement. In those cases, the lessor determines fair value in the same way as a manufacturer or dealer lessor. This guidance may not frequently be relevant to real estate lessors entering into leases for properties they acquired in the past – e.g. entering into a new office or retail space lease in a building acquired years prior. [842-30-55-17A]

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For lessors that are manufacturers or dealers, the fair value of the underlying asset is determined under Topic 820 (fair value measurement).

After the lease commencement date, the lessor recognizes:

- interest income on the net investment in the lease;
- variable lease payments as income in the income statement in the period in which the changes in facts and circumstances on which those payments are based occur; and
- impairment of the net investment in the lease. [842-30-25-2, 25-9]

After the lease commencement date, the lessor measures the net investment in the lease by: [842-30-35-1]

- increasing the carrying amount to reflect interest income resulting from accretion of the lease receivable and the unguaranteed residual asset (and recognition of deferred selling profit, if any, for direct financing leases); and
- reducing the carrying amount to reflect lease payments received.

The lessor uses the effective interest method to both (1) amortize the lease receivable and (2) accrete the unguaranteed residual asset to its estimated future value at the end of the lease term.

A lessor only remeasures its net investment in the lease after initial measurement if the lease is modified and that modification is not accounted for as a separate contract.

Chapter 7 in the Handbook addresses lessor accounting. Specifically, the following additional guidance about the initial and subsequent accounting for sales-type and direct financing leases may be particularly relevant to real estate lessors.

Net investment in the lease	Paragraphs 7.3.10–7.3.47
Lease receivable	Paragraph 7.3.50
Selling profit/loss and initial direct costs	Paragraph 7.3.60 Paragraphs 7.3.90–7.3.110
Unguaranteed residual asset	Paragraph 7.3.70
Recognition of selling profit in a direct financing lease	Examples 7.3.10, 7.3.40
Accounting for initial direct costs in a sales-type lease	Example 7.3.20
Sale of the lease receivable	Paragraph 7.3.420
Accounting for the underlying asset at the end of the lease term	Paragraph 7.3.430
Accounting for lease terminations	Paragraphs 7.3.440–7.3.450

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Operating leases

For operating leases, at the commencement date the lessor:

— continues to recognize the underlying asset and will continue to depreciate it over its estimated useful life; [842-30-30-4]
— continues to measure the underlying asset in accordance with other US GAAP, including testing for impairment in accordance with the guidance on impairment or disposal of long-lived assets; and [842-30-35-6]
— defers any initial direct costs. [842-30-25-10]

After the commencement date: [842-30-25-11]

— Lease payments under the contract are recorded as receivables only when they are due and payable by the lessee. Consequently, there is no interest income recognition.

— Lease income is recognized on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset.

— Variable lease payments are recorded as income in the income statement in the period in which the changes in facts and circumstances on which those payments are based occur.

— Variable non-lease payments are recorded in income in the income statement when the requirements of the applicable Topic (e.g. Topic 606) are met.

— Initial direct costs are recognized as expense over the lease term on the same basis as lease income.

Paragraphs 7.4.10–7.4.40 in the Handbook provide additional guidance about the initial and subsequent accounting for operating leases.

Gross vs net considerations

General guidance on lessor costs

Lessors frequently incur costs in their role as lessor or as owner of the underlying asset that they aim to recover from the lessee. Examples include property, ad valorem and other taxes, and insurance covering the underlying asset. [842-10-15-30(b), ASU 2018-20.BC14]

Lessors typically aim to recover these costs from the lessee, the payments for which do not result in the transfer of a good or service to the lessee in addition to the lease and any non-lease goods or services included in the contract. [842-10-15-30(b), ASU 2018-20.BC14]

— In a gross lease, the lessor recovers the costs through fixed lease payments.

— In a net lease, the lessee makes variable payments, either to the lessor or directly to the third party to whom the cost is owed (e.g. a taxing authority or insurer).

In a gross lease, the lessor's costs and the lessee's fixed lease payments are recognized separately (i.e. on a gross basis) as operating expenses and lease

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income. If the lease includes non-lease components, there will be lease and non-lease income arising from the payments.

In a net lease, gross or net income statement presentation by the lessor depends on whether the lessee or the lessor pays the relevant third party for the cost, unless the cost is a sales or other similar tax (see below). [842-10-15-40A]

- If the **lessee** remits payment to the third party, the lessor presents the cost and the lessee's payment to the third party thereof on a net basis – i.e. with zero effect on the income statement. The lessor, in effect, treats the cost as a lessee cost. Example 4.2.50 in the Handbook illustrates this scenario.
- If the **lessor** remits payment to the third party, the lessor presents the cost and the lessee's variable payments thereof on a gross basis – i.e. as its own cost and income. Example 4.2.40 in the Handbook illustrates this scenario.

In applying the guidance on net leases, it does not matter for lessor accounting purposes whether the lessor or lessee is primarily obligated to the third party for the cost incurred, or who primarily benefits from the cost. Questions 2.3.20 and 2.3.30 in this publication provide additional guidance.

Sales and other similar taxes

The general guidance on lessor costs does not apply to sales and other similar taxes if the lessor elects the practical expedient to present all sales tax collections from lessees (whether fixed or variable) net of the related sales tax expense for all of its leases. Question 2.3.40 in this publication outlines a lessor's accounting for sales and other similar taxes. [842-10-15-39A]

'Sales and other similar taxes' refers to taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction. Other similar taxes include use, value-added taxes (VAT) and some excise taxes. Such taxes exclude (1) gross receipts taxes and (2) taxes assessed on the lessor as owner of the underlying asset. [842-10-15-39A]

Taxes assessed on the lessor as owner of the underlying asset include (not exhaustive): [ASU 2018-20.BC14]

- most property taxes; and
- sales taxes assessed on the owner's purchase of the underlying asset.

A lessor that does *not* elect the practical expedient applies the general guidance on lessor costs to sales and other similar taxes.

Sections 7.3.2 and 7.4.2 in the Handbook address subsequent accounting for lessors. Specifically, the following additional guidance about gross versus net considerations is provided.

Lessor costs in net leases – gross vs net	Paragraphs 7.3.160–7.3.200 Paragraphs 7.3.260–7.3.300 Paragraph 7.4.25
Sales and other similar taxes	Paragraphs 7.3.210–7.3.250 Paragraphs 7.3.310–7.3.320 Paragraph 7.4.25

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In addition, Questions 4.1.50 and 4.1.60 in this publication address gross versus net considerations for sublessors.

Comparison to legacy GAAP

Although the lessor accounting model under Topic 842 is not fundamentally changed from the lessor accounting model under Topic 840, there are important changes that will affect many lessors.

— **Changes in lease classification between sales-type and direct financing leases:** Sales-type leases and direct financing leases are no longer differentiated by whether there is manufacturer/dealer profit or loss. Instead, they are differentiated by whether the lessor effectively transfers control of the underlying asset to the lessee or, instead, transfers substantially all of the risks and benefits of ownership of the underlying asset to the lessee and an unrelated third party.

— **Recognition of selling profit:** If selling profit arises from a direct financing lease, it is deferred and recognized over the lease term.

— **Narrowed definition of initial direct costs:** Under Topic 842, initial direct costs include only those incremental costs of a lease that would not have been incurred if the lease had not been executed. Therefore, some costs (e.g. legal fees and allocated internal costs) that an entity capitalized as initial direct costs under Topic 840 will be expensed as incurred under Topic 842.

— **Allocation of consideration in the contract to lease and non-lease components (if the non-separation practical expedient is not applied):** Under Topic 842, lessors apply the transaction price allocation guidance in Topic 606, while under Topic 840, lessors applied the relative stand-alone selling price guidance in Subtopic 605-25 (revenue recognition – multiple-element arrangements), which differed from that in Topic 606 in some important respects (e.g. allocation of variable consideration, permissible use of a residual approach in some circumstances).

Paragraphs 7.3.460–7.3.510, and 7.4.50–7.4.60 in the Handbook provide additional guidance comparing Topic 842 to legacy GAAP for sales-type/direct financing leases and operating leases, respectively.

Question 3.2.01

Effect of a government grant toward the cost of an underlying asset on the asset's fair value

How does a grant, received by a lessor from a governmental agency as an incentive to build an asset to be leased, affect the asset's fair value?

Interpretive response: If the lessor is neither a manufacturer nor a dealer, the fair value of the underlying asset at lease commencement is its cost; cost reflects any volume or trade discounts that may apply. Because the government grant is available to any lessor that would construct the facility, we believe the

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total cost of the facility should be reduced by the government grant to determine its fair value.

Question 7.3.01 in the Handbook provides additional background.

Question 3.2.02

Fair value in a build-to-suit lease

If construction of a new asset takes significant time, and is completed close to the lease commencement date, should the cost of the asset be considered its fair value if the lessor is not a manufacturer or dealer?

Interpretive response: Yes. We believe the construction completion date should be considered the acquisition date of the asset. Therefore, if the lessor is not a manufacturer or dealer, and there is no significant time lapse between the construction completion date and lease commencement, the fair value of the asset is its cost, reflective of any volume or trade discounts applied.

This guidance is reproduced from Question 7.3.02 in the Handbook.

Question 3.2.10

Estimated residual value of land in a long-term sales-type or direct financing lease

When a long-term land lease is determined to be a sales-type or direct financing lease, can the estimated residual value of the land (undiscounted) exceed its fair value at the lease commencement date?

Background: For both sales-type and direct financing leases, the lessor's net investment in the lease includes the unguaranteed residual asset for the lessor's interest in the underlying asset's estimated future value at the end of the lease term.

A lessor initially measures the unguaranteed residual asset as the present value of the amount that the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

Interpretive response: No. We believe the estimated, undiscounted residual value of the land in a long-term sales-type or direct financing lease is limited to its fair value as of the lease commencement date.

Question 7.3.10 in the Handbook provides additional background and guidance.

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Question 3.2.20

Assessing whether a tax is a lessee or lessor cost

How does a lessor determine whether a tax is a lessee or a lessor cost?

Background: The primary obligor of property or other taxes on real estate assets can vary by jurisdiction – e.g. the primary obligor for property or other taxes in one US state may be the lessor, while in another US state it may be the lessee. It can also vary for other reasons, such as the type of leased asset. This can add complexity to determining whether the lessee's payment of property and other taxes is payment of a lessor cost (which therefore should be included by the lessor in lease or variable lease income).

Before ASU 2018-20 was issued, Topic 842 required a lessor to evaluate whether it was the primary obligor for each type of tax in each taxing jurisdiction (e.g. each state, county or city). This was required to determine whether the tax was a lessee or a lessor cost, and therefore whether the tax and the lessee's payment thereof should be presented net or gross.

Interpretive response: After issuance of ASU 2018-20, lessors no longer determine whether a tax is a lessee or a lessor cost based on who is the primary obligor of the tax.

Instead, the following applies regardless of who is the primary obligor of the tax.

— If the lessee remits payment for the tax to the taxing authority (e.g. pays the property tax on a leased property directly to the relevant city, county or town), the lessor will account for the tax as a cost of the lessee.

— If the lessor remits payment for the tax to the taxing authority, the lessor will account for the tax as its own cost.

As an exception, the sales and other similar taxes practical expedient applies if the lessor elects it *and the tax is an 'in-scope' tax* (see Question 2.3.40 in this publication).

This guidance is reproduced from Question 7.3.60 in the Handbook. Additional guidance about accounting for costs paid by the lessee is provided in Questions 2.3.20–2.3.40 in this publication.

Question 3.2.25

Lease incentives paid before lease commencement

How should a lessor account for a lease incentive paid before lease commencement?

Interpretive response: If a lessor pays a lease incentive to a lessee before lease commencement, the lessor records the lease incentive paid as a deferred

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cost. The accounting at lease commencement then depends on the classification of the lease.

- For sales-type and direct financing leases, the deferred cost is derecognized:
  - as a reduction of the selling profit (or increase in the selling loss) arising from the lease (see section 3.2 in this publication); or
  - against sales/product revenue if the lessor presents revenue and cost of goods sold for its leases separately (see paragraph 7.7.20 in the Handbook).
- For operating leases, the lessor commences amortization of the deferred cost, which will be recognized as a reduction of lease income over the lease term on the same basis as lease income (generally, straight-line) (see section 3.2 in this publication).

This guidance is reproduced from Question 7.3.25 in the Handbook.

Question 3.2.26

Contingent lease incentives

How should a lessor account for contingent lease incentives it offers to the lessee?

Background: Lessors frequently offer lease incentives that are contingent on future events or lessee actions – i.e. the incentives are not paid or payable – at lease commencement. For example, lessors offer to reimburse lessees for all or a portion of the cost of leasehold improvements. To receive the reimbursement, the lessee must construct or install the leasehold improvements and provide evidence of the costs incurred.

Interpretive response: We believe that if the occurrence of the future event or change in circumstance that triggers the contingent lease incentive (or portion thereof) is probable at lease commencement and the amount is reasonably estimable, the expected amount should be estimated and accounted for by the lessor as a negative in-substance fixed lease payment – i.e. as a reduction of 'lease payments'. The expected timing of payment should also be considered when discounting the lease payments for classification and measurement (if a sales-type or direct financing lease) purposes.

If the lessor does not include a contingent lease incentive in the lease payments at lease commencement – i.e. because payment of the incentive is not probable and/or not reasonably estimable – we believe the lessor can elect as an accounting policy to either recognize the incentive (1) as a 'negative' variable lease payment in the period the change in facts or circumstances on which the relevant payment is based occurs or (2) over the remaining lease term , either with cumulative effect or prospectively.

Question 7.3.26 in the Handbook provides additional background and guidance. Example 7.3.25 in the Handbook compares the accounting for a sales-type lease with and without a contingent lease incentive.

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Question 3.2.30

Lessor reassessment of key lease estimates and judgments

Do lessors reassess key lease estimates and judgments after lease commencement?

Interpretive response: Lessors do not reassess key lease estimates and judgments after lease commencement – e.g. lease classification, lease term, the likelihood of the lessee to exercise a purchase option, or the discount rate on sales-type and direct financing leases – unless the lease is modified and that modification is not accounted for as a separate contract.

This guidance is reproduced from Question 7.3.70 in the Handbook. Paragraphs 7.3.360–7.3.370 in the Handbook provide additional guidance.

Question 3.2.40

Assessing the net investment in the lease for impairment

Does the lessor consider the cash flows it expects to be able to receive from the underlying asset after the end of the lease term when evaluating its net investment in a sales-type or direct financing lease for impairment under Topic 310 (and for credit losses under Subtopic 326-20 after adopting ASU 2016-13)?

Interpretive response: Yes. The cash flows that can be obtained from sale or re-lease of the underlying asset following the end of the lease term *should* be considered as part of the collateral relating to the net investment in the lease when assessing the net investment for impairment. [842-30-35-3]

The unit of account for assessing impairment of the net investment in the lease is the entire net investment in the lease, inclusive of any residual asset. A lessor evaluates its entire net investment in the lease for impairment using the cash flows associated with the leased asset during and following the lease term. Those cash flows include an assumed lump-sum payment related to the residual asset at the end of the lease term (e.g. from sale of the asset at auction). [ASU 2016-02.BC311]

Question 7.3.80 and paragraphs 7.3.390–7.3.410 in the Handbook provide additional guidance.

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Question 3.2.45

Sale of future operating lease payments that do not meet definition of a receivable

How does a lessor account for the sale of future operating lease payments that do not yet meet the definition of a receivable subject to Topic 860?

Background: The sale of a sales-type or direct financing lease receivable is accounted for under Topic 860 (transfers and servicing), consistent with any other sale of a financial asset. [860-10-55-6, ASU 2016-02.BC317]

The sale of an operating lease receivable is also accounted for under Topic 860. However, the sale of future operating lease payments that do not meet the definition of a receivable – including those amounts that arise solely from the requirement in Topic 842 to recognize operating lease income on a straight-line basis but do not meet the definition of a receivable – are not subject to Topic 860. [860-10-15-5, 15-4(b)]

Interpretive response: We believe the proceeds from the sale of these payments should be treated as debt in a manner consistent with the accounting that applies to proceeds received from the sale of future revenues under Topic 470 (debt) when the seller has significant continuing involvement in the generation of the revenues. Section 3.7.30 of KPMG Handbook, Debt and equity financing, provides guidance on the accounting for the sale of future revenues.

This guidance is reproduced from Question 7.4.05 in the Handbook.

Question 3.2.50

Uneven lease payments intended to compensate for expected changes in market rent

Should a lessor recognize lease income on a cash basis if uneven payments are intended to reflect the parties' expectations about market rental prices throughout the lease term?

Interpretive response: No. Operating lease income must be recognized 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. Changes in market rent that are expected to occur during the lease term do not reflect changes in expected *usage* of the underlying asset, and therefore are not an appropriate basis on which to deviate from straight-line income recognition. [842-30-25-11, 55-17]

Question 7.4.10 in the Handbook provides additional guidance.

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Question 3.2.52

Operating lease income in lease with non-consecutive period of use

Should a lessor in an operating lease with a non-consecutive period of use recognize lease income during periods the lessee does not have the right to use the underlying asset?

Interpretive response: No. Operating lease income should be recognized only during the periods the lessee has the right to use the underlying asset. [842-30-25-11(a)]

For example, assume a lessee leases retail store space in a shopping mall from the lessor during the holiday season (October 15 through January 15) each year for three years in a lease classified as an operating lease. In this case, the lessor should recognize operating lease income (including any variable lease income) only during October 15 through January 15 each year; no lease income should be recognized outside of that time window.

This guidance is reproduced from Question 7.4.15 in the Handbook. Example 5.3.40 in the Handbook illustrates determining the term for a lease with a non-consecutive period of use.

Question 3.2.53

Single lease cost attribution – operating lease with non-consecutive period of use that is variable at lease commencement

How should a lessor recognize lease cost in an operating lease with a variable number of non-consecutive use periods?

Interpretive response: Topic 842 does not specifically address a situation in which the period of use comprises a variable number of non-consecutive periods. Consequently, and in the absence of additional guidance in GAAP or from the SEC staff, we believe that any one of the following three approaches may be acceptable. Facts and circumstances may affect whether all three approaches would be acceptable in every scenario.

Approach 1: Assume the minimum number of use periods, and treat each addition thereto as a change in the lease term

Under this approach, the lessor bases its lease income recognition on the minimum number of periods the lessee will have the right to use the asset. The lessor does *not* estimate expected additional use periods.

Each time the minimum number of periods the lessee will have the right to use the underlying asset increases, this reflects a change in the lease term. While the term is not necessarily being extended in these cases (i.e. the last non-consecutive use period may still be the same), it *is* being changed to reflect a different number of non-consecutive use periods. [842-10-35-1(c), 35-3]

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Approach 2: Estimate the total number of periods of use at lease commencement, and revise periodically

Under this approach, the lessor estimates the total number of periods that the lessee will have the right to use the asset using an appropriate systematic and rational approach.

Lease income is then recognized in equal amounts each period the lessee has the right to use the asset.

The lessor revises its estimate of the total number of periods the lessee will have the right to use the asset periodically throughout the lease term when facts and circumstances indicate its current estimate is no longer reasonable.

Consistent with Approach 1, we believe a change to the lessor's estimate constitutes a change to the lease term and the lessor should account for such changes in the same manner.

Approach 3: Treat each year of the contract as the lease income unit of account

Under this approach, which we do not believe will be practicable or appropriate in all scenarios involving a period of use with a variable number of non-consecutive use periods, the lessor makes its estimates of usage for multiple shorter periods within the longer contract period, rather than for the entire contract period.

This approach differs from Approach 2 principally in that it recognizes and attributes equal lease income each year, and estimates usage only for the current year. In contrast, Approach 2 would only *coincidentally* result in equal lease income recognition each year, and estimates usage for the entire contract period.

Question 6.4.15 in the Handbook applies these approaches to a background example and Question 7.4.16 provides additional guidance.

Question 3.2.54

Curtailment of the lessee's right to use the underlying asset

Should an operating lessor stop recognizing, or recognize reduced, operating lease revenue when the lessee's rights to use the underlying asset have been curtailed?

Background: Situations arise in which the lessee's ability to use, and derive its intended economic benefits from using, the underlying asset are significantly curtailed. For example, as a result of COVID-19, retail store locations in shopping centers were closed to the public such that the retailer (lessee) could not sell its goods from the location, and restaurants were precluded from seating customers in their dining rooms (i.e. limiting their operations to carry-out or delivery only). Similar circumstances may arise during periods of civil unrest or natural disasters.

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The question arises as to whether it is appropriate to suspend or reduce operating lease revenue recognition during the curtailment period.

Interpretive response: We believe it is inappropriate to suspend or reduce operating lease revenue recognition as long as the lessee retains the right to use the underlying asset, even in a significantly curtailed manner.

The retailer in the background example cannot sell to customers from the location, but it has not vacated the space – e.g. its inventory is still stored there, and its leasehold improvements remain in place. Therefore, the retailer still retains control over the use of the space – i.e. control has not reverted to the landlord such that the landlord can use the space itself or re-lease it.

As long as the lessee retains its right to use the underlying asset, the lessor is still performing (fulfilling its obligation) under the lease and should not suspend its revenue recognition. And because Topic 842 equates control over the use of an underlying asset with physical use, the lessor should not change its straight-line revenue recognition pattern during the curtailment period based on any estimate of the reduced utility or economic benefits from use of the asset to the lessee. [842-20-55-3]

This guidance is reproduced from Question 7.4.17 in the Handbook .

Question 3.2.55

Lessor accounting for reimbursements of capital replacements and repairs in an operating lease

When should a lessor recognize revenue from lessee reimbursements of a capital replacement/repair that is not a promise to the customer in an operating lease?

Background: A lessor frequently has the contractual right to pass through costs of capital replacements or repairs to its tenants. For example, if a lessor installs a new roof on its property, the tenants may be required to reimburse the lessor for those costs.

A common reimbursement arrangement is for tenants to reimburse the lessor consistent with the useful life of the replacement/repair and consistent with the lessees' proportionate rights to use the property.

It is also common that the lessee's reimbursement obligation ends if the lease expires. In contrast, if the lessee early terminates the lease, often the lessor has the right to recover the amounts it would have obtained from the lessee related to the capital replacement/repair over the remainder of the lease term.

For example, Lessee LE leases 10% of a shopping center's available retail space for 10 years. At the beginning of Year 2, Lessor LR installs a new $450,000 roof on the shopping center that has a 15-year useful life. Under the terms of the lease, LE will reimburse LR $3,000 per year for the remaining 9 years of the lease term ($27,000 total): ($450,000 total cost / 15 years) × 10% occupancy.

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In this example (and similar scenarios), the question arises about whether LR should recognize the entire reimbursement ($27,000) on a discounted basis on completion of the capital replacement/repair, or instead should recognize $3,000 each year when it has the contractual right to the payment.

Interpretive response: We believe the lessor should recognize the reimbursement amount to which it expects to be entitled from a lessee for capital replacements/repairs that are not promises to the customer (see Question 2.3.15 in this publication) in an operating lease over the remainder of the lease term – i.e. $3,000 per year in the background example.

This amount should not include additional reimbursements to which the lessor will be entitled if the lease term is extended. A lessor should *not* recognize the full amount of the reimbursement when the replacement/repair is completed.

Even though the capital replacement/repair is complete and the amount of the reimbursement is known, the reimbursement is not earned, and therefore should not be recognized, at that time. This is because Topic 842 treats operating leases as executory contracts *for lessors only*. Therefore, the lessor's entitlement to the reimbursement amount depends on it continuing to fulfill the executory operating lease – i.e. continuing to permit the lessee to use the underlying asset.

This guidance is reproduced from Question 7.4.20 in the Handbook.

3.2.20 Collectibility reassessment

A lessor does not reassess lease classification unless the lease is modified and that modification is not accounted for as a separate contract (see section 3.4 in this publication). Therefore, changes in the assessment of collectibility after the commencement date do not affect the classification of the lease, regardless of whether the change is positive (i.e. collectibility becomes probable) or negative (i.e. collectibility is determined to no longer be probable). For example, a lease that was classified as an operating lease at lease commencement solely because of collectibility issues is not reclassified as a direct financing lease if collectibility subsequently becomes probable. [842-10-25-3(b)(2), 842-30-55-25 – 55-30, 55-40 – 55-43]

In July 2019, the FASB staff responded to a multi-faceted technical inquiry about lessors' accounting for operating lease receivables after the adoption of Topic 842. Many aspects of the inquiry arose because of the FASB's decision to exclude operating lease receivables from the scope of the credit losses guidance in Topic 326. Questions 3.2.70 through 3.2.120 in this publication relate to this technical inquiry.

COVID-19 effects

KPMG Hot Topic, Lease accounting impacts of COVID-19, provides guidance on the lease accounting impacts of the economic and financial market effects of COVID-19, including operating lease income recognition and evaluating collectibility.

In April 2020, a FASB staff Q&A was issued that provides guidance on rent concessions granted in response to COVID-19. The guidance applies only to

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such concessions. KPMG Hot Topic, FASB staff guidance on COVID-19 rent concessions, provides guidance on the practical expedient and answers questions about its application. KPMG Hot Topic, Accounting for coronavirus-related rent concessions, provides guidance on how to account for COVID-19 related rent concessions for which the practical expedient is not (or cannot) be applied. Section 3.3 of this publication provides additional information.

Question 3.2.60

Impact of collectibility reassessment on lessors

How do the collectibility reassessment requirements in Topic 842 affect lessors?

Interpretive response: The following is a summary of how collectibility is assessed for different leases.

Type of lease	Collectibility probable at lease commencement?	After initial recognition
Sales-type	Yes	No ongoing monitoring of collectibility; perform impairment test of net investment in lease.
	No	Ongoing monitoring of collectibility.
Direct financing[1]	Yes	No ongoing monitoring of collectibility; perform impairment test of net investment in lease.
Operating	Yes	Ongoing monitoring of collectibility.
	No	Ongoing monitoring of collectibility.

Note:

1. A lease cannot be classified as a direct financing lease if collectibility is not probable at lease commencement.

Changes in the assessment of collectibility after the commencement date do not affect the classification of the lease, regardless of whether the change is positive (i.e. collectibility becomes probable) or negative (i.e. collectibility is determined to no longer be probable).

Questions 7.5.10-7.5.70 in the Handbook provides additional guidance about how lessors should consider collectibility and Paragraphs 7.5.10–7.5.210 provide additional guidance and observations.

Questions 3.2.70–3.2.120 in this publication provide additional guidance on assessing collectibility of operating lease receivables.

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Question 3.2.70

Collectibility of operating lease receivables – lease-by-lease basis

Does Topic 842 require lessors to assess collectibility for operating leases on a lease-by-lease basis?

Interpretive response: Yes. Collectibility must be assessed for each operating lease. While we believe this is established by the guidance in Subtopic 842-30, it was also affirmed by the FASB staff as part of their response to a recent technical inquiry. [842-30-25-12 – 25-13, ASU 2016-02.BC105]

This guidance is reproduced from Question 7.5.20 of the Handbook.

Question 3.2.80

Collectibility of operating lease receivables – ongoing assessment

Does Topic 842 require lessors to assess collectibility throughout the lease term?

Interpretive response: Yes. Subtopic 842-30 includes guidance on accounting for changes in the assessment of collectibility for an operating lease 'after the commencement date', clearly indicating that collectibility for an operating lease is an ongoing assessment throughout the lease term. This intent was affirmed by the FASB staff as part of their response to a recent technical inquiry. [842-30-25-13]

This guidance is reproduced from Question 7.5.30 of the Handbook.

Question 3.2.90

Collectibility of operating lease receivables – leases subject to the collectibility constraint

Should operating lease receivables for leases subject to the collectibility constraint be fully reserved for on the lessor's balance sheet?

Interpretive response: Yes. If, at lease commencement, an operating lease is subject to the collectibility constraint (i.e. collectibility of substantially all the lease payments and any amount necessary to satisfy a residual value guarantee is not probable), no receivables for that lease should be recognized on the lessor's balance sheet until collectibility becomes probable. A lessor may accomplish this by either not recognizing the receivables, or fully reserving for those receivables through an allowance.

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If an operating lease is *not* subject to the collectibility constraint at lease commencement, but becomes subject to it during the lease term, a reserve should be established for 100% of any outstanding lease receivables.

This guidance is reproduced from Question 7.5.40 of the Handbook.

Question 3.2.100

Collectibility of operating lease receivables – leases not subject to constraint

Should a lessor recognize a reserve for operating lease receivables *not* of a lease subject to the collectibility constraint after adopting Topic 842?

Interpretive response: Based on a technical inquiry with the FASB staff, we believe either of the following two accounting policies is acceptable as an accounting policy election to be applied consistently.

Approach 1: Follow Subtopic 842-30 guidance only

The basis for conclusions to ASU 2018-19, which scoped operating lease receivables out of Topic 326, may be read to indicate that the Subtopic 842-30 collectibility guidance is the only guidance to apply when considering impairment of operating lease receivables. [ASU 2018-19 Summary, ASU 2018-19.BC14]

Consequently, operating lease receivables should be impaired (i.e. written off or reserved for) only when the lease is subject to the collectibility constraint. No 'general reserve' should be established or maintained for other operating lease receivables.

Approach 2: Establish a general reserve based on Subtopic 450-20

In deciding to exclude operating lease receivables from the scope of Topic 326, the FASB reiterated its intent, originally expressed in the basis for conclusions to ASU 2016-02, not to *significantly* change lessors' accounting for operating leases. [ASU 2016-02.BC90–BC92, ASU 2018-19.BC13]

Excluding operating lease receivables from the scope of Topic 326 was intended to be consistent with the intent not to significantly change operating lease accounting. It was *not* intended to preclude lessors from recording a general reserve for operating lease receivables *after* applying the collectibility constraint guidance in Subtopic 842-30. Therefore, the FASB staff believes it is acceptable for a lessor to recognize a reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.

Applying Approach 2 does not affect a lessor's requirement to fully reserve for operating lease receivables subject to the collectibility constraint (see Question 3.2.90 in this publication).

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Question 3.2.110

Collectibility of operating lease receivables – accounting for a general reserve

If a lessor follows Approach 2 to Question 3.2.100, should the general reserve be recorded through a reduction to lease revenue or bad debt expense?

Interpretive response: Based on a technical inquiry with the FASB staff, we believe either of the following two accounting policies is acceptable as an accounting policy election to be applied consistently.

Approach 1: Record changes to the reserve through lease revenue

All changes to the balance of the general reserve (i.e. increases and decreases) established under Subtopic 450-20 are recorded through lease revenue. This approach generally results in consistency in the income statement between where lessors (1) record changes to their general reserve and (2) record the effect of a lease becoming subject to, or leaving, the collectibility constraint.

Approach 2: Record bad debt expense

All changes to the balance of the *general* reserve (see Question 3.2.100 in this publication) are recorded through bad debt expense. In accepting this approach, the FASB staff again cited the FASB's expressed intent not to *significantly* change lessors' accounting for operating leases, and noted that lessors have typically established, and recorded changes to, general operating lease receivable reserves through bad debt expense. [ASU 2018-19 Summary, ASU 2018-19.BC14]

This guidance is reproduced from Question 7.5.60 of the Handbook.

Question 3.2.120

Collectibility of operating lease receivables – impact of constraint on general reserve

How should a lessor record the effect of becoming subject to the collectibility constraint after lease commencement if it maintains a general reserve?

Background: For this question, consider the following example.

- Lessor LR is the lessor in an operating lease with Lessee LE. LE has a $100 outstanding lease receivable balance – arising from the straight-lining of lease revenue – at the date LR concludes that collectibility of substantially all the remaining lease payments is not probable.
- LR maintains a general reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.
- Using a systematic and rational approach, LR determines that $5 of the general reserve is attributable to the lease with LE. To make this

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determination, LR evaluates its general reserve inclusive and exclusive of the lease with LE.

— LR's assessment of collectibility does not change again during the lease term after the lease with LE becomes subject to the collectibility constraint.

Interpretive response: Based on a technical inquiry with the FASB staff, we believe any of the following three approaches is acceptable as an accounting policy election.

There is no financial reporting difference between the approaches for a lessor that follows Approach 1 to Question 3.2.110 in this publication – i.e. records all changes to its general operating lease receivable reserve through lease revenue. Therefore, this response assumes the lessor elects Approach 2 to Question 3.2.110 – i.e. records changes to its general reserve through bad debt expense.

Approach 1: Record the effects on a gross basis

The lessor first reserves for the entire outstanding balance of the receivables for the operating lease through a reduction to lease revenue, then records any necessary change to the general reserve for the effects of removing the troubled lease from the general reserve portfolio through bad debt expense. From the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example, at the date LR's assessment of collectibility for the lease changes, LR will recognize:

— a $100 specific reserve for LE's outstanding receivables, offset by a $100 current period reduction to lease revenue; and
— a $5 reduction to the general operating lease receivable reserve, offset by a $5 reduction to current period bad debt expense.

From the reassessment date, LR will recognize revenue on the lease each period equal to cash received.

Approach 2: Record the effects on a net basis

The lessor records a reduction to lease revenue that is *net* of the portion of the general reserve that can be attributed to the lease receivables now subject to the collectibility constraint. Consistent with Approach 1, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example, at the date LR's assessment of collectibility for the lease changes, LR will:

— reallocate the $5 of the general reserve that can be attributed to the LE lease to a specific reserve for the LE lease; and
— recognize an additional $95 specific reserve for the LE lease, offset by a $95 current period reduction to lease revenue.

From the reassessment date, LR will recognize revenue on the lease each period equal to cash received.

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Approach 3: Consider the nature and purpose of the lessor's general reserve

Consistent with Approaches 1 and 2, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

However, under this approach, in contrast to the others, a lessor may *not* record a reduction to lease revenue in the period that its assessment of collectibility changes. This would be true if the lessor's general reserve methodology contemplates, and therefore establishes general reserves sufficient to absorb, periodic lease-specific credit impairments (like the background example). In that case, if collectibility of a lease that became subject to the collectibility constraint during the lease term subsequently becomes probable, the remainder of the specific reserve for the lease receivables should be reallocated to the general reserve. Any reversal of the specific reserve arising from the collectibility constraint – e.g. if collectibility again becomes probable – should not result in additional lease revenue or a reduction to bad debt expense, because it was originally established through an allocation from the general reserve.

Determining whether a lessor's general reserves are sufficient to absorb lease-specific credit impairments will likely involve judgment. However, we believe that if the lessor needs to significantly increase its general reserve at or shortly after a lease-specific credit impairment event – to address the risk of non-collection for its remaining population of operating leases not subject to the collectibility constraint – that would be evidence contrary to concluding that the lessor's general reserve is sufficient to absorb lease-specific credit impairments.

Using the background example, assume that LR's general reserve is determined to be sufficient to absorb the LE lease credit impairment. At the date LR's assessment of collectibility for the lease changes, LR will reallocate $100 of the general reserve to a specific reserve for the LE lease; no reduction to lease revenue or additional bad debt expense will be recorded.

From the reassessment date, LR will recognize revenue on the lease each period equal to cash received.

This guidance is reproduced from Question 7.5.70 of the Handbook.

3.3 Lease modifications

A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease; for example, a change that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term. [842 Glossary]

The effective date of a lease modification is the date that the modification is approved by both the lessee and the lessor. [842 Glossary]

A key question that drives the accounting for a modification is whether the modification should be accounted for as a separate contract.

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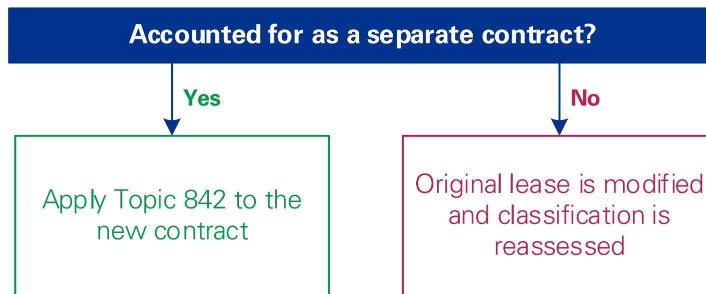

A modification is accounted for as a separate contract when it both: [842-10-25-8]

— grants the lessee an additional right of use that was not included in the original contract – e.g. the right to use an additional asset; and
— the lease payments increase commensurate with the stand-alone price for the additional right of use, as adjusted for the circumstances of the particular contract.

An increase to the lease term (e.g. a modification changing the lease term from four to six years) does not grant the lessee an additional right of use. [842-10-25-11]

If a lease is modified and that modification is not accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification, based on the modified terms and conditions and the facts and circumstances as of that date – e.g. the fair value and remaining economic life of the underlying asset at that date. The accounting for lease modifications not accounted for as a separate contract depends on the classification of the modified lease. [842-10-25-9]

When a lessee exercises an option to extend a lease (including by electing not to exercise a termination option) or to purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise, the lessor accounts for the exercise of that option as a lease modification. [842-10-35-3]

Likewise, if a lessee does not exercise an option the lessor previously determined the lessee was reasonably certain to exercise, the non-exercise of the option is accounted for as a lease modification. Similarly, if a lessee exercises a termination option it was previously reasonably certain *not* to exercise, that is accounted for as a lease modification. [842-10-35-3]

A 'modification' that results from the exercise of a termination option or a purchase option is effectively one that terminates the lease. That is, a lease no longer exists once the lessee has either terminated the lease or has purchased the underlying asset.

The following charts summarize how to account for a lease that is modified, and the modification does not result in a separate contract.

Operating lease modifications

If an operating lease is modified and the modification does not result in a separate contract, the lessor accounts for the modification as if the original

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lease is terminated, and a new lease commences on the effective date of the modification. [842-10-25-15]

Original Lease	Modified Lease	Requirements
Operating →	Operating	Lessor includes any prepaid or accrued lease rentals relating to the original lease in the lease payments for the modified lease.
Operating →	Sales-type or direct financing	Lessor derecognizes any deferred rent liability or accrued rent asset and adjusts the selling profit (loss) accordingly, which is deferred in the case of a direct financing lease.

Direct financing lease modifications

Lessor accounting for a direct financing lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-16]

Modified lease is:	
Operating lease	Carrying amount of underlying asset = Net investment in original lease immediately before effective date of modification
Sales-type lease	Account for modified lease in accordance with sales-type lease guidance in Subtopic 842-30 with effective date of modification as commencement date of lease[1]
Direct financing lease	Adjust discount rate so initial net investment in modified lease = Carrying amount of net investment in original lease immediately before effective date of modification

Sales-type lease modifications

Lessor accounting for a sales-type lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-17]

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Modified lease is:	
Operating lease	Carrying amount of underlying asset = Net investment in original lease immediately before effective date of modification
Sales-type or direct financing lease	Adjust discount rate so initial net investment in modified lease = Carrying amount of net investment in original lease immediately before effective date of modification

Chapter 7 in the Handbook addresses lessor accounting. Specifically, the following additional guidance about accounting for lease modifications may be particularly relevant to real estate lessors.

Guidance and observations about lease modifications	Paragraphs 7.6.10–7.6.160
Comparison to legacy US GAAP	Paragraphs 7.6.170–7.6.180
Modification date – lessee fails to give termination notice	Example 7.6.07**
Operating lease modification for a rent deferral	Example 7.6.08
Operating lease remains an operating lease after a lease-term extension	Example 7.6.10
Sales-type lease remains a sales-type lease after a change to the lease payments	Example 7.6.20
Direct financing lease becomes an operating lease after a lease-term extension	Example 7.6.30

COVID-19 rent concessions

In April 2020, the FASB staff issued a Q&A that provides a practical expedient for COVID-19 related rent concessions that meet specified conditions. The guidance applies only to such eligible concessions; it cannot be analogized to concessions arising from other similar events (e.g. a natural disaster or recent civil unrest in Hong Kong).

The practical expedient permits a company to choose to forgo an evaluation of the enforceable rights and obligations of the original lease contract. Instead, the company may account for COVID-19 related rent concessions, whatever their form (e.g. rent deferral, abatement or other) either:

— *as if* they were part of the enforceable rights and obligations of the parties under the existing lease contract; or
— as a lease modification (see section 3.3 in this publication for guidance on lessor accounting for lease modifications).

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The practical expedient is available to all lessors applying US GAAP, regardless of whether they have adopted Topic 842 or are still applying Topic 840 (e.g. a private company that has not yet adopted Topic 842).

Eligible concessions are those that are COVID-19 related and where the changes to the lease resulting from and accompanying the concession do not result in a substantial increase to the rights of the lessor or the obligations of the lessee. As an example, the staff refers to leases for which the total payments required by the contract will be substantially the same or less than the total payments required by the contract pre-concession as eligible for the practical expedient.

KPMG Hot Topic, FASB staff guidance on COVID-19 rent concessions, provides guidance on applying and determining eligibility for the practical expedient.

KPMG Hot Topic, Accounting for coronavirus-related rent concessions, provides guidance on how to account for rent concessions resulting from COVID-19 for which the practical expedient is not (or cannot be) applied.

Question 3.3.05

Contract modifications not in writing

Do contract modifications have to be in writing?

Interpretive response: No. Under Topic 842, a contract can be oral or implied as long as it creates enforceable rights and obligations on the contracting parties. Similarly, a modification to a contract can also be oral or implied, as long as it is enforceable. [842 Glossary]

An example of an implied modification is a lessee's construction or installation of lessor-owned improvements to the underlying asset (see Question 3.1.120) not required by the lease contract. Even if no amendment is executed, it is implied that the lessor agreed to the lessee's actions (see Question 5.4.85 in the Handbook).

Question 7.6.05 in the Handbook provides additional examples of contract modifications that may not result in or from written changes to the terms and conditions of the lease contract.

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Question 3.3.05A**

Contract changes only affecting variable or contingent payments

Does a lease contract change that affects only variable or contingent payments for the lease qualify as a lease modification?

Background: A lessor and lessee may modify the terms of a lease contract in a manner that *only* adds new, or changes existing, variable or contingent lease payments. Relevant examples could include adding or changing:

— a variable payment based on a percentage of the lessee's sales or the lessee's usage of the underlying asset;
— a payment that changes based on increases or decreases in the CPI; or
— a contingency in the lease contract that could change the amount of the payments the lessee will make under the lease.

In these circumstances, the 'lease payments' and/or the 'consideration in the contract' may not change, so some have questioned whether these changes are lease modifications under Topic 842.

Interpretive response: Yes. A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. Variable and contingent payments are part of the consideration for a lease; therefore, changes to (including the addition of) such payments change the consideration for the lease and give rise to a lease modification.

This guidance is reproduced from Question 7.6.05A in the Handbook.

Question 3.3.06

Rent concessions

Is a rent concession a modification?

Applicability: This question does not apply to eligible COVID-19 related concessions of a lessor that has elected the practical expedient offered by the FASB staff specific to COVID-19 related rent concessions. If the lessor has elected the practical expedient and the rent concession in question is COVID-19 related, see KPMG Hot Topic, FASB staff guidance on accounting for COVID-19 rent concessions.

Interpretive response: It depends. We believe the first step to answer this question is to determine whether:

— the lessee had an enforceable right to the concession before it was granted; and
— other terms and conditions of the contract that affect the scope of or consideration for the lease were changed.

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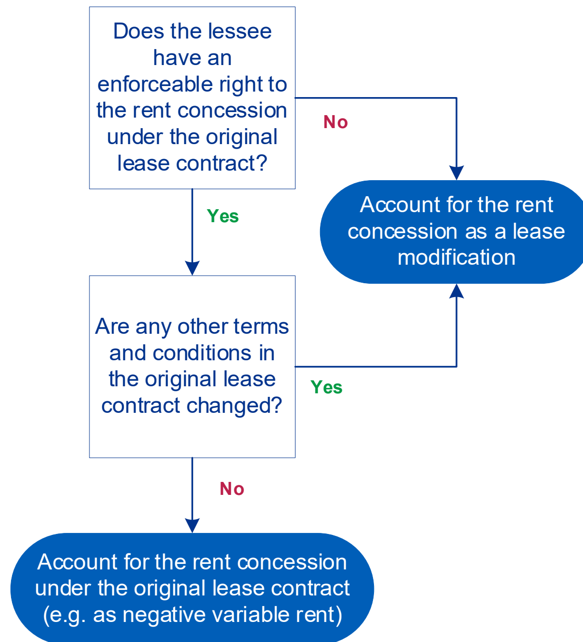
The following diagram illustrates the evaluation and its result on the lessor's accounting.



Question 7.6.06 in the Handbook provides additional background and guidance on how to apply the framework illustrated in the diagram above.

Accounting consequences

If there is a lease modification, lessors will account for the modification consistent with any other modification.

If the lessee has an enforceable right to the rent concession for the affected period(s) and there are no other changes to the terms and conditions of the original lease contract, there is no lease modification. The lessor should continue to account for the lease under the original contract. In the case of a rent forgiveness or a rent abatement, we believe the lessor should generally account for the rent reduction as negative variable lease revenue, consistent with lessor accounting for a co-tenancy clause (see Question 3.3.10).

Question 3.3.07

Lessee short payment of rent

How does a lessor account for a lessee making rent payments that are less than the amount contractually owed (i.e. 'short payment')?

Interpretive response: The first step to accounting for a short payment is to determine whether the lessee is entitled to make the short payment under the

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existing lease contract – i.e. whether, based on the terms and conditions of the contract, the lessee has the enforceable right to pay the lesser amount.

If so, we believe the lessor should generally account for the rent reduction as *negative* variable lease income of the period to which the short payment relates. This is consistent with how a lessor accounts for a co-tenancy clause (see Question 3.3.10).

If the enforceable rights and obligations of the lease contract do not permit the lessee to short pay the rent, the lessor will continue to account for the lease under its original terms and conditions unless and until a modification is approved. In general, for a typical real estate operating lease, this means lease income will continue to be based on the rental payments to which the lessor is entitled. However, an exception arises if the lessor concludes that the lessee's short payment makes it no longer probable that the lessor will collect at least substantially all the lease payments to which it is entitled under the original contract. See section 3.2.20 for information about a lessor's accounting when this occurs

If a modification is approved, the lessor will apply modification accounting as illustrated throughout section 3.3 from the 'effective date of the modification'.

Question 7.6.06A in the Handbook provides additional guidance and Example 7.6.06A illustrates lessor accounting for short payments of rent not permitted by the lease contract.

Note: An exception to the preceding paragraph arises if the modification constitutes a concession (see Question 3.3.06) resulting from COVID-19, the concession qualifies for the FASB staff's practical expedient for COVID-19 related rent concessions and the lessor has elected the optional practical expedient to account for the concession as if it was required under the original lease contract. See KPMG Hot Topic, FASB staff guidance on accounting for COVID-19 rent concessions, for guidance.

Question 3.3.08

Lessor consideration of a lessee's notice to exercise its purchase option

How should a lessor account for the notification that a lessee plans to exercise a purchase option that was not previously considered to be reasonably certain of exercise?

Interpretative response: The lessor evaluates whether the lessee's notification of its intent to exercise the purchase option creates or changes the enforceable rights and obligations of the lease arrangement. [842 Glossary, 606-10-25-10, 842-10-35-3]

— If the notification legally obligates the lessee to purchase the underlying asset, the lessor should account for the notification as a modification of the lease arrangement, using the notification date as the 'effective date of the modification' (see section 3.3 in this publication).

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— If the notification does not legally obligate the lessee to purchase the underlying asset, there is no modification of the agreement. As a result, there is no change to the lessor's accounting for the operating lease.

Question 7.6.07 in the Handbook provides additional background and includes guidance for how to account for the notification that results in a lease modification.

Question 3.3.10
Co-tenancy clauses

How should a lessor account for a co-tenancy clause that reduces the lessee's rent when it is triggered?

Interpretive response: Many retail leases include co-tenancy clauses that reduce the tenant's contractual rent if, for example, a key (or anchor) tenant (e.g. a department or 'big box' store) or a certain number of tenants vacate the property. Typically, these clauses stipulate that the tenant must resume paying the contractual rent either after a specified period of time or when the co-tenancy event is cured (e.g. a new anchor tenant occupies the relevant space vacated by the previous anchor tenant).

At lease commencement, we believe the lessor's accounting for the lease should not consider the co-tenancy clause being triggered.

If the co-tenancy clause is triggered during the lease term, this would not be considered a lease modification by the lessor because: [842 Glossary, 842-10-35-3]

— there has been no change to the terms and conditions of the lease; and
— the lessee has not exercised an option to extend the lease or purchase the underlying asset it was not reasonably certain to exercise previously.

Therefore, the lease would not be remeasured. Instead, the difference between the lessee's actual payments and the fixed payment that would have applied if the co-tenancy clause had not been triggered should be treated as negative variable rent.

Question 7.6.10 in the Handbook provides additional background and guidance.

Question 3.3.20
Modifications that add a right(s) of use *and* make other changes

Can a contract modification that adds a lessee right of use, but also includes other changes, be accounted for as a separate contract?

Background: To illustrate, consider a scenario in which a lessee leases three floors of an office building from a lessor for an original term of five years. In

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Year 3, the lessor enters into an amendment with the lessee to lease it a fourth floor. In addition to the fourth-floor lease, they agree to:

- extend the non-cancellable period for the three original floors to match the non-cancellable period of the new, fourth floor lease; and/or
- reduce the lease payments for the original three floors to reflect the price per square foot the lessee is paying for the fourth-floor lease.

Interpretive response: No. A contract modification can only be accounted for as a separate contract if the only change to the existing contract is to add an additional right of use to the contract – e.g. adding another floor to an existing office space lease as in the background example. [842-10-25-8]

If changes are also made to one or more existing lease components, the separate contract guidance in paragraph 842-10-25-8 does not apply. In that case, it is not appropriate to bifurcate the additional right of use and the other changes and assess the additional right of use separately under the separate contract guidance. [ASU 2016-02.BC171–BC172]

This guidance is reproduced from Question 7.6.06B in the Handbook.

Question 3.3.30

Lessee exercise of options other than to extend the lease or purchase the underlying asset

How does a lessor account for lessee election of an option other than to extend the lease or purchase the underlying asset?

Background: As outlined in section 3.3 of this publication, Topic 842 requires that when a lessee exercises an option to extend a lease or to purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise, the lessor accounts for the exercise of that option as a lease modification. [842-10-35-3]

Topic 842 does not specifically address other lessee options that may exist in a lease contract – e.g. a unilateral option to revise the lease payment structure from one comprised of fixed and variable payments to fixed payments only. The question therefore arises as to the lessor's accounting if the lessee elects the option.

Interpretive response: In the absence of specific lessor guidance around lessee options other than those to extend the lease or purchase the underlying asset, we believe it is appropriate for a lessor to analogize to that guidance. That is, we believe a lessor should account for a lessee's exercise of any unilateral option not already factored into the lessor's pre-exercise lease accounting as a lease modification.

We believe this is consistent with the US GAAP principle of first looking to other authoritative GAAP that applies to the entity for similar transactions or events when there is not authoritative US GAAP guidance for the specific transaction or event in question. In this case, the guidance referred to in the

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background applies to all lessors, and we believe a lessee's exercise of an option such as that described in the background, albeit a different type of option, is a similar transaction or event. [105-10-05-2]

Question 7.6.20 in the Handbook provides additional background.

3.4 Financial statement presentation

A lessor is required to present the following items arising from leases in the scope of Topic 842.

Balance sheet	
Sales-type and direct financing leases	Present the net investment in sales-type and direct financing leases separately from other assets. The net investment is subject to the same classification considerations as other assets on a classified balance sheet – i.e. current versus noncurrent.
Operating leases	Present the underlying asset and related depreciation expense in accordance with other US GAAP (e.g. Topic 360), as applicable.
Income statement	
All leases	Present lease income separately or disclose the line item(s) in the income statement in which lease income is included.
Sales-type and direct financing leases	Present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model.
Statement of cash flows	
All leases	Classify all cash receipts from leases as cash flows from operating activities. An exception applies if the lessor is a financial institution in the scope of Topic 942 and the lease is a sales-type or direct financing lease.

Chapter 14 in KPMG Handbook, Statement of cash flows, addresses cash flow presentation issues specific to lessors under Topic 842. Chapter 7 in the Handbook, Leases, addresses lessor accounting. Specifically, the following additional guidance about financial statement presentation may be particularly relevant to real estate lessors.

Guidance, observations and comparison to legacy US GAAP	Paragraphs 7.7.10–7.7.50
Cash flow statement presentation for cash received for sales-type and direct finance leases	Question 7.7.10
Presentation and classification of initial direct costs	Question 7.7.20

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Question 3.4.10

Separate income statement presentation of tenant reimbursements

Is a lessor that elected the lessor non-separation practical expedient permitted to separately present tenant reimbursements in its income statement?

Background: Under Topic 840, lessors (particularly real estate lessors) frequently adopted a practice for net leases of presenting the following separately:

- revenue from the base rental payments due under a lease; and
- tenant reimbursements of lessor executory costs such as property taxes, insurance and maintenance (including common area maintenance).

Many lessors have elected (or will elect) the practical expedient to not separate lease and non-lease components (see section 2.5 in this publication). In addition, as discussed in section 3.2 in this publication, lessors are required to recognize tenant reimbursements of lessor costs on a gross basis (i.e. as additional lease revenue). Some of these lessors have questioned whether it is acceptable under Topic 842 to continue to present the revenue from the base rental payments due under a lease separately from tenant reimbursements of lessor property tax, insurance and/or common area maintenance (CAM) costs.

Interpretive response: No. If a lessor has elected the non-separation practical expedient, it is not permitted to present these tenant reimbursements separately from the lease revenue related to the base rent. This is because all of the payments (base rent payments and tenant reimbursements) relate to a single lease (or non-lease – see section 2.5 in this publication) component. It would not be appropriate to separately present revenue from the two different payment streams for the same component.

However, one exception might apply. As discussed in section 2.5 in this publication, a contract might contain a non-lease component that does not qualify for the non-separation practical expedient. In that case, any portion of a tenant's reimbursements appropriately allocated to that non-lease component may be recognized in an income statement line item separate from the lessor's lease revenue. For example, a portion of a variable payment for the reimbursement of lessor property taxes may – depending on the facts and circumstances – be allocated to a non-lease component such as a supply of goods that is not eligible to be combined with the lease component and is required to be presented in an income statement line item different from where the lessor presents revenue for the lease.

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4. Other considerations

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

4.1 Subleases

Questions

4.1.10 Accounting for the head lease when a sublease exists

4.1.20 Impact of sublease renewal options on head lease term

4.1.30 Sublessor reassessments

4.1.40 Impact of sublessee actions on sublessor accounting for the head lease

4.1.45 Loss-making sublease entered into before head lease commencement

4.1.50 Sublessor gross vs net considerations

4.1.60 Sublessor rental payments directly to a third party

4.2 Sale-leaseback accounting

Questions

4.2.05 Sale of construction-in-progress to be leased back in completed form

4.2.10 Finance/sales-type leaseback

4.2.20 Sale-leaseback with seller-lessee leasing portion of the asset back under a finance/sales-type lease

4.2.21 Accounting for portion of a transferred asset subject to a failed sale/purchase that is not leased back

4.2.30 Seller-lessee repurchase option involving real estate

4.2.40 Seller-lessee right of first offer

4.2.50 Seller-lessee participation in buyer-lessor financing

4.2.60 Different conclusions by the seller-lessee and buyer-lessor

4.2.70 Buyer-lessor accounting for initial direct costs incurred in a failed sale-leaseback transaction

4.2.80 Other considerations that demonstrate lessee control of an asset under construction

4.2.90 Lessor accounting when lessee controls the underlying asset under construction

4.2.95 Accounting for the transfer of construction-in-progress in a build-to-suit scenario **

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4.2.100 Build-to-suit applicability when an underlying asset is modified

4.2.110 Identifying the underlying asset under construction

4.2.120 Lease of to-be-constructed property improvements on land sold by the lessee to the lessor

4.3 Income taxes

Questions

4.3.10 Related party leases #

4.3.20 Intercompany operating leases – REIT and taxable REIT subsidiary

4.4 Leases acquired in a business combination

Questions

4.4.03 Reassessment of lease identification

4.4.04 Acquiree assessment of lease classification or lease identification is not known or is not made under US GAAP

4.4.05 Acquirer and acquiree adopted Topic 842 at different dates – reassessment of lease identification

4.4.06 Different acquirer and acquiree transition elections

4.4.07 Only the acquirer or the acquiree has adopted Topic 842 – reassessment of lease identification

4.4.10 Lease classification when lease is modified in a business combination

4.4.20 Acquiree's lease classification retained from Topic 840

4.4.25 Reassessment of lease classification – only the acquirer has adopted Topic 842

4.4.30 Lease classification when lease is acquired in an asset acquisition

4.4.40 Accounting for leases acquired in an asset acquisition

4.4.50 In-place leases

4.4.60 Lease classification impact on the measurement of underlying assets

4.4.65 How off-market lease terms affect the fair value of the underlying asset in sales-type and direct financing leases

4.4.70 Acquisition accounting for an acquired failed sale/purchase

4.4.80 Different acquirer/acquiree separation of lease and non-lease component policy elections

4.5 Disclosures

Questions

4.5.10 Interim disclosure requirements

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4.5.20	Annual disclosures in interim filings in the year of adoption
4.5.30	Assets subject to operating leases as a separate major class of depreciable asset
4.5.40	Separate disclosure of tenant reimbursements

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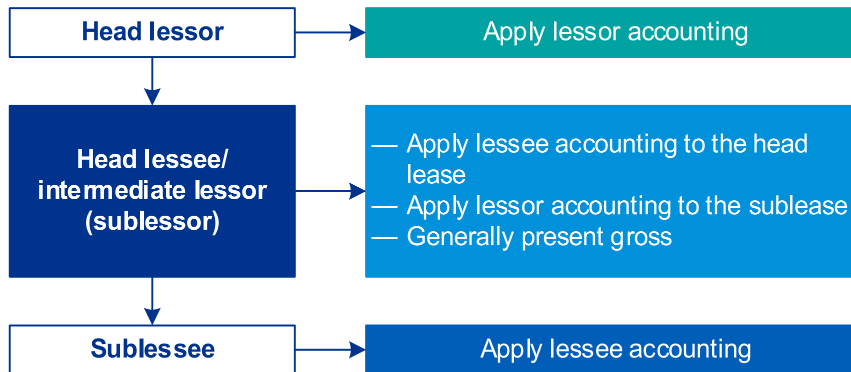
4.1 Subleases

The following flowchart summarizes the accounting for each party to a lease and sublease transaction.



The sublessor and sublessee classify a sublease by reference to the underlying asset subject to the lease, rather than by reference to the ROU asset. This means that, in determining the classification of the sublease, the sublessor and the sublessee consider:

— the term of the sublease as compared to the remaining economic life of the underlying asset – rather than, for example, the remaining term of the head lease; and

— the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee as compared to the fair value of the underlying asset – rather than the fair value of the head lease ROU asset.

We expect that most subleases under Topic 842 will be classified as operating leases by sublessors.

The head lease and the sublease will generally be accounted for separately – i.e. as two separate units of account. This is because, even if the contracts are entered into at or near the same date, the sublessee is generally a third party unrelated to the head lessor. Two or more contracts are potentially combined under Topic 842 only if they are entered into at or near the same time and with the same counterparty (or a related party of the counterparty). [842-10-25-19, ASU 2016-02.BC115]

The sublessor generally presents the expense on the head lease separately from the income on the sublease (i.e. gross presentation) in its income statement.

Chapter 8 in the Handbook addresses subleases. Specifically, the following additional guidance may be particularly relevant to real estate sublessors.

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Determining the discount rate for the sublease	Paragraphs 8.2.30–8.2.40 Question 8.2.10
Determining whether a sublessor has been relieved of its primary obligation under the head lease	Question 8.2.20
Accounting when the sublessor is not relieved of its primary obligation under the head lease	Paragraph 8.2.80
Accounting when the sublessor is relieved of its primary obligation under the head lease	Paragraphs 8.2.100–8.2.120
Sublessor recognition of profit (loss) on a sales-type or direct financing sublease	Question 8.2.30
Sublease presentation by sublessors (balance sheet)	Question 8.2.40
Sublease presentation by sublessors (income statement)	Question 8.2.50
Classification and accounting for a sublease transaction by a sublessor in a warehouse lease	Example 8.2.10
Comparison to legacy US GAAP	Paragraphs 8.2.130–8.2.150

Question 4.1.10

Accounting for the head lease when a sublease exists

Does entering into a sublease with a term longer than the remaining head lease term trigger a remeasurement of the head lease?

Interpretive response: Yes. Two parties may enter into a sublease where the non-cancellable period of the sublease, or the sublease term (i.e. including one or more optional periods), exceeds the lease term for the head lease. The act of entering into the sublease is a significant event within the control of the sublessor that directly affects the assessment of the lease term. Therefore, the sublessor needs to update the head lease term to be at least equal to the sublease term, which will then trigger a remeasurement of the head lease. [842-10-55-28]

Question 8.1.10 in the Handbook provides additional guidance.

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Question 4.1.20

Impact of sublease renewal options on head lease term

Does the head lease term include all renewal options that the head lessee (sublessor) can be required to exercise under the terms of a sublease?

Interpretive response: Not necessarily. We believe entering into a sublease that includes renewal options that could compel the sublessor to exercise one or more renewal options it has in the head lease does not automatically trigger a change to the head lease term.

Entering into the sublease is a significant event within the control of the head lessee such that the head lessee needs to reassess the lease term at that time. However, unless the sublessee is reasonably certain to exercise its renewal option, the sublessee's renewal option will not, in isolation, trigger a change to the head lease term (and therefore a remeasurement of the head lease liability). [842-10-35-1, 55-28]

In the Handbook, Question 8.1.20 provides additional guidance about sublease renewal options, and Question 8.1.30 provides guidance about sublease purchase options.

Question 4.1.30

Sublessor reassessments

Do sublessors ever reassess their accounting for a sublease absent a modification?

Interpretive response: No. Sublessors do not reassess their accounting for the sublease – e.g. reassess the sublease term or sublessee purchase options – after the commencement date unless the sublease is modified (and that modification is not accounted for as a separate contract).

Question 8.1.40 in the Handbook provides additional guidance.

Question 4.1.40

Impact of sublessee actions on sublessor accounting for the head lease

Do sublessee actions trigger reassessments of the head lease by the sublessor?

Interpretive response: In general, no. We believe that sublessors are not required to monitor for any changes to the *sublessee's* facts or circumstances in accounting for the head lease. Rather, consistent with any other lease for

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which the sublessor is a lessee (i.e. those leases not subject to a sublease), the sublessor only reassesses its accounting for the head lease upon the occurrence of a significant event or change in circumstances within its control. For example, while the sublessor may be aware of the sublessee constructing significant leasehold improvements or making significant customizations to the underlying asset, assuming such actions are not within the sublessor's control.

However, if a sublessor has provided a residual value guarantee to the head lessor, the sublessor will need to monitor whether there are changes in the amount probable of being owed to the head lessor under the residual value guarantee.

Question 8.1.50 in the Handbook provides additional guidance.

Question 4.1.45

Loss-making sublease entered into before head lease commencement

Does a sublessor recognize a loss accrual upon entering into a loss-making sublease before the head lease commencement date?

Background: Assume a sublessor enters into a ten-year noncancellable head lease. Before head lease commencement, the sublessor enters into a sublease. The sublease rental payments are less than the head lease payments such that the sublessor will incur a loss on the sublease.

In this scenario, the question arises as to whether the sublessor is required (or permitted) to recognize the sublease loss at sublease inception.

Interpretive response: No, we believe the sublessor should not record a sublease loss accrual at sublease inception. Our view is based on the combined effect of the following.

— We believe sublease losses are outside the scope of Topic 450 (contingencies).
— Lessors in a head lease do not recognize onerous contract provisions for loss-making leases; instead, a loss-making lease affects whether the underlying asset is impaired.
— Loss accruals on revenue contracts are recognized only in specific circumstances under Topic 606 that are not analogous to leases.
— Topic 842 does not appear to contemplate pre-head-lease-commencement sublease loss accruals because it does not provide any guidance on how to account for such accruals after head lease commencement.

Question 8.2.35 in the Handbook provides additional commentary about the basis for our view.

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Question 4.1.50

Sublessor gross vs net considerations

Does a sublessor follow the gross vs net considerations guidance for sublessee payments of lessor costs?

Background: Consider a scenario in which Head Lessee (Sublessor) LE and Head Lessor LR enter into a five-year lease of a building. Under the head lease, LE is required to make variable payments of LR's property taxes and insurance directly to the taxing authority and insurer, respectively. LE subsequently subleases the building to Sublessee SE and the sublease agreement transfers to SE the obligation to pay the property taxes and insurance on the building to the taxing authority and insurer. There are no non-lease components in either the head lease or sublease contracts.

Interpretive response: Yes. The gross versus net considerations in section 3.2 in this publication apply equally to head lessors and sublessors. This is because sublessors apply Topic 842's lessor accounting requirements to the sublease.

Using the background scenario to illustrate, LE presents its head lease building property tax and insurance costs and SE's variable payments thereof on a net basis – i.e. LE does not recognize either variable head lease cost or variable sublease income because those amounts are equal and therefore net to zero.

Changing the background scenario, assume LR pays the taxing authority and the insurer for the property taxes and insurance, LE is required to reimburse LR and SE is required to reimburse LE in turn. In that scenario, LE would present its variable property tax and insurance payments to LR and SE's variable property tax and insurance payments to LE on a gross basis – i.e. as variable head lease cost and variable sublease income, respectively.

This guidance is reproduced from Question 7.3.40 in the Handbook.

Questions 2.3.20–2.3.40 and 3.2.20 in this publication provide additional discussion of gross versus net considerations for lessor costs.

Question 4.1.60

Sublessee rental payments directly to a third party

Do the gross vs net lessor cost requirements apply to variable rent payments?

Background: It may occur that a sublessee is required to make variable rent payments directly to the head lessor, rather than to the sublessor.

For example, Head Lessee (Sublessor) LE may sublease a building and its underlying land to Sublessee SE. LE previously owned the building and leased the underlying land from Landowner. LE sold the building and leases it back from Head Lessor LR. After the sale-leaseback transaction with LR, LE retains

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the requirement to make variable rent payments to Landowner for the ground lease. However, SE assumes the obligation to make those variable rent payments to Landowner as part of the sublease.

In this scenario, the question arises about whether LE should present the variable rent paid by SE directly to Landowner on a gross or a net basis.

Interpretive response: No. We do not believe the gross versus net considerations in section 3.2 of this publication apply to variable rent payments, or any variable payments that relate to a non-lease component of the contract.

At a February 2018 FASB meeting, the Board affirmed the view of the FASB staff that the gross versus net guidance related to lessor costs applies only to lessee payments of the types of costs contemplated by paragraph 842-10-15-30(b) – i.e. costs incurred by the lessor in its role as lessor or as owner of the underlying asset, such as those from property taxes or insuring the underlying asset. The basis for conclusions to ASU 2018-20 effectively defines 'lessor costs' for the purposes of the guidance in that manner. [ASU 2018-20.BC14]

In the background example, this means that LE should account for SE's variable rent payments to Landowner on a gross basis – i.e. separately recognizing variable lease cost and variable sublease income. This is regardless of whether SE reports the amount of the payments to LE; if SE does not do so, LE must estimate the amount of the payments.

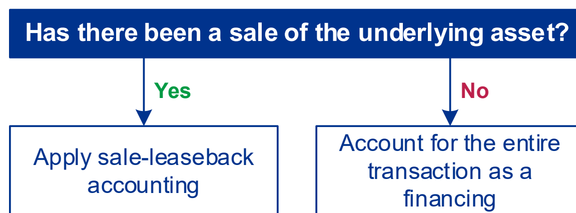
This guidance is reproduced from Question 7.3.50 in the Handbook.

Questions 2.3.20–2.3.40 and 3.2.20 in this publication provide additional discussion of gross versus net considerations for lessor costs.

4.2 Sale-leaseback accounting

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then leases that asset back from the buyer-lessor.

Driving the accounting is whether a sale (seller-lessee) and purchase (buyer-lessor) has occurred. This determination is made by each party applying the guidance in Topic 606 to determine whether (1) there is a contract between the parties, and (2) a customer has obtained control of a good.



Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. [606-10-25-25]

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Lessee involvement in the construction or design of the underlying asset

If a lessee controls an underlying asset that is under construction (or redesign) before the commencement date – i.e. it is the 'accounting owner' of the asset – the transaction is a sale-leaseback transaction when construction is complete and the asset is available for use (usually at lease commencement). [842-40-55-5]

In evaluating whether a lessee is the accounting owner of an asset under construction, Topic 842 focuses on whether the lessee controls the underlying asset before the lease commencement date. The guidance states that any one of the following characteristics would demonstrate that the lessee controls the underlying asset before the lease commencement date (list not exhaustive). [842-40-55-5]

— The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).

— The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor.

— The lessee legally owns both the land and the property improvements that are under construction, or the non-real estate asset that is being constructed (e.g. a ship or aircraft).

— The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land before the beginning of construction that, together with the renewal options[1], permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.

— The lessee is leasing the land on which the property improvements will be constructed, the term of which, together with lessee renewal options[1], is for substantially all of the economic life of the property improvements and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.[1]

Note 1: 'Options' refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. Therefore, this criterion considers the maximum possible lease term, rather than the 'lease term' as defined in Topic 842.

Transaction qualifies as sale/purchase

When a sale/purchase occurs in the context of a sale-leaseback transaction, at the point in time that the buyer-lessor obtains control of the asset (under Topic 606), the buyer-lessor accounts for the: [842-40-25-4(b)]

— purchase of the underlying asset in a sale-leaseback transaction consistent with the guidance that would apply to any other purchase of a nonfinancial asset (subject to any off-market adjustment) – i.e. without the presence of a leaseback; and

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— leaseback under the lessor accounting model.

Unless the sale-leaseback transaction is between related parties, the sale/purchase is accounted for at fair value. Therefore, both the seller-lessee and the buyer-lessor need to assess whether the transaction is at fair value – i.e. at market terms. [842-40-30-1]

In assessing whether the transaction is at fair value, an entity uses the formula that is more readily determinable: [842-40-30-1]

— the sales price of the asset versus the fair value of the asset; or
— the present value of the lease payments versus the present value of market rental payments

If the sale-leaseback transaction is between related parties, neither the seller-lessee nor the buyer-lessor adjusts for off-market terms. Instead, the entity discloses the off-market nature of the transaction.

If the sale-leaseback transaction is not at fair value, the entity (whether the seller-lessee or the buyer-lessor) adjusts the sales price so that the transaction is recognized at fair value: [842-40-30-2]

— **Deficit.** If the sales price is less than fair value, an adjustment is made to increase the sales price of the asset. The corresponding debit is recognized as a rent prepayment.

— **Excess.** If the sales price is greater than fair value, an adjustment is made to decrease the sales price of the asset. The corresponding credit is recognized as additional financing provided by the buyer-lessor to the seller-lessee.

Transaction does not qualify as a sale/purchase

If the transaction does not qualify as a sale/purchase, it is accounted for as a financing.

— The seller-lessee recognizes proceeds received from the buyer-lessor as a financial liability (financing method) and does not derecognize the transferred asset. The seller-lessee continues to depreciate the transferred asset.

— The buyer-lessor does not recognize the transferred asset and accounts for proceeds paid to the seller-lessee as a receivable (financial asset).

A transaction that does not meet the criteria to be accounted for as a sale/purchase (i.e. that is a 'failed sale/purchase') remains a failed sale/purchase until the requirements to account for it as a sale/purchase are met.

For example: [842-40-55-31 – 55-38, ASU 2016-02.BC369]

— the buyer-lessor may obtain control of the asset (and therefore complete the sale/purchase) before the end of the leaseback term if a seller-lessee repurchase option (or other specific feature) that precluded sale/purchase accounting expires; or
— the control guidance in Topic 606 may suggest that the buyer-lessor has not obtained control of the asset at the leaseback commencement date, but may suggest otherwise before the end of the leaseback term.

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If an initially failed sale-leaseback transaction qualifies for sale/purchase accounting before the end of the leaseback term: [842-40-55-31 – 55-38]

— the seller-lessee derecognizes the remaining financial liability and the carrying amount of the asset, and recognizes a gain for the difference; and
— the buyer-lessor derecognizes its remaining financial asset and recognizes the transferred asset at that same amount.

Both parties then account for the remaining leaseback in accordance with the applicable lessee and lessor guidance from the date the sale/purchase is deemed to occur for accounting purposes. However, they both use the discount rate for the lease that would have been established at the contractual lease commencement date.

Chapter 9 in the Handbook addresses sale-leaseback accounting. Specifically, the following additional guidance may be particularly relevant to real estate buyer/lessors.

Determining whether a sale/purchase has occurred	Paragraphs 9.1.10–9.1.100 Paragraphs 9.1.130–9.1.170
Sale/purchase recognition before commencement of the leaseback	Question 9.1.25
Sale-leaseback guidance applicability – finance lease modified to become an operating lease	Question 9.1.12**
Sale or assignment of a lessee purchase option	Question 9.1.15
Evaluating whether guarantees or indemnities provided by the seller-lessee preclude sale-leaseback accounting	Question 9.1.60
Conflicting transfer of control indicators	Question 9.1.70
Determining whether a sale/purchase has occurred when the seller-lessee has a repurchase option	Example 9.1.10
Evaluating whether a seller-lessee's ability to share in income or profits of the underlying asset affects sale-leaseback accounting	Question 9.1.90
Identifying the unit of account for determining whether a sale/purchase has occurred in a sale-leaseback transaction	Question 9.1.110
Comparison to legacy US GAAP	Paragraphs 9.1.180–9.1.250 Paragraphs 9.3.090–9.3.110
Which formula to apply when evaluating whether a sale-leaseback is at fair value	Question 9.2.10
Other considerations related to off-market terms	Paragraphs 9.2.80–9.2.90 Paragraph 9.2.130
Related party transactions	Paragraph 9.2.100–9.2.110
Accounting when a failed sale-leaseback later qualifies for sale-leaseback accounting	Paragraphs 9.3.40–9.3.80
Lease classification when a failed sale-leaseback later qualifies for sale-leaseback accounting	Question 9.3.30

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Failed sale-leaseback transaction – buyer-lessor accounting	Example 9.3.30
Lessee control before lease commencement ('build-to-suit' leases)	Paragraphs 9.4.10–9.4.80
Control of an underlying asset pre-lease commencement when multiple parties are involved	Question 9.4.05**
Lessee call options exercisable only on occurrence of a contingent event	Question 9.4.10
Lessee call options exercisable only at a future date	Question 9.4.11
Lessee call options that expire before the end of the construction period	Question 9.4.12
Meaning of 'at any point' when evaluating lessee call options	Question 9.4.15
Lessee put options	Question 9.4.20
Land lease at below-market rent	Question 9.4.30
Lessee participation in construction period financing	Question 9.4.40
Comparison to legacy US GAAP – build-to-suit leases	Paragraphs 9.4.90–9.4.120
Sale of tax benefits	Question 9.5.10 Paragraphs 9.5.10–9.5.20

Question 4.2.05

Sale of construction-in-progress to be leased back in completed form

If a lessee sells construction-in-progress to an unrelated third party that agrees to finish construction and lease the completed asset back to the lessee, is the transaction a sale-leaseback?

Background: An entity (seller) may begin construction of an asset before transferring that asset to an unrelated third party (buyer) that will finance completion of the asset and then lease the completed asset to the seller. The progress toward completion of the construction-in-progress (CIP) at the time of sale may vary.

For example, for a building, it may be that:

- the land has been cleared and/or graded to prepare for construction;
- a physical structure has begun to be erected – e.g. a foundation laid and steel beams erected;
- it is a cold shell – typically a building that lacks heating and cooling, ceilings and interior wall finishings; or

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— it is a warm shell – typically a building that includes interior ceilings and walls, lighting, heating/cooling and plumbing.

Interpretive response: It depends. Topic 842 does not address this question, and the FASB did not publicly discuss it during the deliberations of Topic 842. Consequently, multiple views have emerged in practice.

Those views range from:

— accounting for the transaction as a sale-leaseback, subject to Subtopic 842-40, once any 'hard costs' have been incurred (e.g. costs to clear and grade the land on which a building will be constructed), no matter how insignificant; to
— accounting for the transaction as a sale-leaseback only if the CIP is 'substantially similar' to the completed asset – i.e. substantially all of the construction is complete.

Between these two ends of the spectrum, others have concluded that sale-leaseback accounting should apply either:

— when a physical structure (e.g. foundation and steel or wood framing for a building) has begun to be erected that will be part of the completed asset; or
— when a substantial portion of the construction is complete, which is typically viewed as far less than the 'substantially all' envisaged in the second view in the preceding paragraph.

In response to this question, the FASB and SEC staffs have expressed the view that there are likely multiple acceptable interpretations about when this type of transaction should be subject to the sale-leaseback guidance in Subtopic 842-40, including all of those outlined in the preceding paragraphs.

Consequently, we believe entities have flexibility, between the two ends of the spectrum described, to establish an accounting policy about when transactions of this nature are subject to the sale-leaseback guidance in Subtopic 842-40. Entities should apply their policy consistently to similar transactions.

Question 9.1.18 in the Handbook provides additional guidance on determining progress toward completion and accounting for these transactions when they are not sale-leasebacks.

Question 4.2.10

Finance/sales-type leaseback

Can the parties apply sale-leaseback accounting when the leaseback is a finance/sales-type leaseback?

Interpretive response: No. It is prohibited to account for a sale and finance (lessee) / sales-type (lessor) leaseback transaction as a sale and a leaseback. The transaction is a failed sale/purchase for both the seller-lessee and the buyer-lessor.

Paragraph 9.1.100 in the Handbook provides additional guidance.

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Question 4.2.20

Sale-leaseback with seller-lessee leasing portion of the asset back under a finance/sales-type lease

If a seller-lessee transfers an asset to a buyer-lessor, but leases back a distinct portion of the asset in a lease that would be classified as a finance/sales-type lease, is the transfer of the asset a failed sale?

Background: Certain assets are, or have the ability to be, divided into distinct units. For example, a building may be divided into separable units (e.g. floors, office suites) or will be legally subdivided (condominiumized). The question arises about whether a sale occurs if an asset is transferred, but the seller-lessee leases back a portion of that asset (e.g. one or more floors of the building under terms that would result in classifying the leaseback as a finance/sales-type lease.

Interpretive response: It depends. If the transferred asset has not been legally subdivided, we believe a finance leaseback of a portion of that asset will result in accounting for the transfer of the asset as a failed sale/purchase unless the portion being leased back is only a minor portion of the legally transferred asset.

If the transferred asset has been legally subdivided, we believe each legally subdivided portion of the larger asset should be evaluated separately. If a 40-story building has been legally subdivided (condominiumized) into 40 units, the finance leaseback of 18 floors (units) would not preclude accounting for the transfer of the other 22 floors (units) as sales. And, in that case, there is no sale-leaseback transaction for the 22 floors (units), because the seller-lessee is not leasing those floors back from the buyer-lessor after they are sold.

Question 9.1.21 in the Handbook provides additional background and guidance.

Question 4.2.21

Accounting for portion of a transferred asset subject to a failed sale/purchase that is not leased back

How does an entity account for the portion of a transferred asset that is not leased back to the seller-lessee when the transaction is accounted for as a failed sale/purchase?

Background: Considering the example in Question 4.2.20, the question arises about how the seller-lessee and the buyer-lessor should account for the 22 floors of the building that are not subject to the contractual leaseback.

Interpretive response: From an accounting perspective, in a failed sale transaction, the seller-lessee remains the accounting owner of the transferred asset (i.e. the 40-story building in the background example), just as if it had never entered into the sale-leaseback transaction with the buyer-lessor.

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However, in the background scenario, the buyer-lessor controls *the use* of the 22 floors that the seller-lessee is not contractually leasing back – i.e. the buyer-lessor can use those floors or lease them to other entities, despite the seller-lessee's continued accounting ownership of the building.

Therefore, we believe it is appropriate for the seller-lessee and the buyer-lessor to account for the lease of the 22 floors from the seller-lessee to the buyer-lessor (i.e. the seller-lessee as accounting lessor, and the buyer-lessor as accounting lessee) just as they would any other lease. This includes evaluating the classification of the implied lease, which could result in sales-type (seller-lessee) or finance (buyer-lessor) lease classification because there is nothing in Topic 842 that would prohibit those classifications in this scenario.

Assuming the buyer-lessor has paid the purchase price for the building upfront, it will treat a portion of that purchase price as prepaid rent for its implied lease of the 22 floors. This reduces the financial liability and receivable recognized by the seller-lessee and buyer-lessor for the failed sale/purchase, respectively.

Topic 842 does not prescribe or illustrate how to account for this type of scenario. Therefore, the above may not be the only acceptable approach

This guidance is largely reproduced from Question 9.1.22 in the Handbook.

Question 4.2.30

Seller-lessee repurchase option involving real estate

Does a seller-lessee repurchase option in a sale-leaseback transaction involving real estate *always* result in a failed sale/purchase?

Interpretive response: Yes. A repurchase option (at any strike price) for a real estate asset will never meet the criterion for there to be alternative assets that are substantially the same as the real estate asset readily available in the marketplace and will always result in a failed sale/purchase in a sale-leaseback transaction. [ASU 2016-02.BC352(c)]

In the Handbook, Question 9.1.30 provides additional guidance about failed real-estate sale-leasebacks, and Question 9.1.40 provides additional guidance about assessing whether assets are 'substantially the same'.

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Question 4.2.40
Seller-lessee right of first offer

Under what circumstances would a right of first offer by a seller-lessee preclude sale-leaseback accounting?

Interpretive response: We believe a right of first offer would preclude sale accounting in a sale-leaseback transaction if either (1) the buyer-lessor is economically or contractually compelled to accept the seller-lessee's offer or (2) the seller-lessee is economically or contractually compelled to make an offer.

In the Handbook, Question 9.1.50 provides additional guidance about (1) and (2), and paragraphs 9.1.110–9.1.120 provide observations about how to approach repurchase options in sale-leaseback transactions.

Question 4.2.50
Seller-lessee participation in buyer-lessor financing

Does seller-lessee participation in the financing of the buyer-lessor affect whether a sale-leaseback transaction qualifies for sale/purchase accounting?

Interpretive response: It depends. In general, the seller-lessee providing a guarantee of the buyer-lessor's debt (or otherwise participating in the buyer-lessor's financing), by itself, does not affect whether the buyer-lessor obtains control of the underlying asset. Absent other provisions, the guarantee (or other participation) alone would not prevent the buyer-lessor from having the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in the same manner as any other lessor that acquires an asset to lease to a third party

The parties would, however, need to consider whether other terms and conditions associated with inducing the seller-lessee to provide the guarantee or otherwise participate in the financing prevent the buyer-lessor from obtaining control of the asset. For example, if, as a condition of providing a loan guarantee, the buyer-lessor is not permitted to sell the underlying asset (even subject to the leaseback) during the leaseback period, that may suggest the buyer-lessor does not have the ability to direct the use of, or obtain substantially all the remaining benefits from, the asset until the leaseback expires.

Question 9.1.80 in the Handbook provides additional guidance and considerations when evaluating whether buyer-lessor financing affects whether a sale-leaseback qualifies for sale/purchase accounting.

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Question 4.2.60

Different conclusions by the seller-lessee and buyer-lessor

Will a seller-lessee and a buyer-lessor reach the same conclusions about whether a sale/purchase has occurred in the context of a sale-leaseback transaction?

Interpretive response: Not always. It is possible that a seller-lessee and a buyer-lessor in a sale-leaseback transaction will not come to the same conclusions about whether a sale/purchase occurs. This could result for any of the following reasons (not exhaustive): [606-10-25-25, 25-30]

- different judgments or estimates;
- different judgments about the nature of the asset;
- different evaluations of the control guidance; or
- effect of variable lease payments on buyer-lessor lease classification after adopting ASU 2021-05.

Question 9.1.100 in the Handbook provides additional guidance.

Question 4.2.70

Buyer-lessor accounting for initial direct costs incurred in a failed sale-leaseback transaction

What guidance should a buyer-lessor apply to determine the initial direct costs in a failed sale-leaseback transaction?

Interpretive response: Topic 842 is not clear as to whether those costs should be accounted for under the leasing or financial instruments guidance.

We believe that because a failed sale-leaseback transaction initially falls within the scope of Topic 842 and then subsequently is accounted for as a loan, either of the above alternatives are acceptable if applied consistently by the buyer-lessor. The guidance in Subtopic 310-20 may result in capitalizing more initial direct costs than those capitalized under Topic 842 because the capitalizable costs under that Subtopic include items that do not meet the definition of initial direct costs under Topic 842.

Question 9.3.40 in the Handbook provides additional guidance on how a buyer-lessor should account for unamortized costs capitalized under Subtopic 310-20 at the point a successful sale-leaseback does occur.

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Question 4.2.80

Other considerations that demonstrate lessee control of an asset under construction

In addition to the factors described in the background section, what should an entity consider in determining whether a lessee controls an underlying asset that is under construction before the commencement date?

Interpretive response: In addition to the factors described in background section (paragraph 842-40-55-5), an entity should evaluate whether the entity's performance creates or enhances an asset (e.g. work in process) that the customer (lessee) controls as the asset is created or enhanced. This is a control-based test that is different from the previous risk-based build-to-suit evaluation under Topic 840.

This evaluation is consistent with one of the factors considered under Topic 606 in determining whether a performance obligation is satisfied, and revenue recognized, over time. [606-10-25-27(b)]

Question 9.4.50 in the Handbook provides additional guidance about evaluating whether the lessee controls an underlying asset as it is being constructed when none of the factors in paragraph 842-40-55-5 are met. Examples 9.4.10 and 9.4.20 in the Handbook illustrate how to determine whether a lessee controls a building as it is being constructed before lease commencement.

Question 4.2.90

Lessor accounting when lessee controls the underlying asset under construction

When a lessee controls (i.e. is the accounting owner of) an underlying asset that is under construction before the lease commencement date, does the lessor account for the arrangement as a sale-leaseback transaction?

Interpretive response: Yes. The lessor accounts for its costs to construct the asset as a loan to the lessee to construct the lessee's asset. At the end of the construction period, the lessor applies the sale-leaseback guidance to determine whether (and when) to recognize the underlying asset.

Question 9.4.60 in the Handbook provides additional guidance.

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Question 4.2.95**

Accounting for the transfer of construction-in-progress in a build-to-suit scenario

How do the lessee and the lessor account for the transfer of existing construction-in-progress from the lessor to the lessee?

Background: The underlying asset that needs to be constructed or redesigned in a build-to-suit lease is frequently not a brand new asset. The lessor may have the underlying asset on its books already as construction-in-progress (CIP).

Interpretive response: We believe the **lessee** should recognize the existing asset as CIP at its then-current fair value with a corresponding financial liability.

Assuming the construction continues to be financed by the lessor, the lessee should increase the CIP and the financial liability as the construction occurs, just as it would if the underlying asset was new construction at contract inception.

We believe the **lessor's** accounting depends on whether it has the obligation (as a principal) to complete the underlying asset's construction, or instead is acting solely as a financing agent for the construction. We believe the principal-agent considerations guidance in Topic 606 (revenue from contracts with customers) provides a relevant framework to make this determination; see chapter 9 of KPMG Handbook, Revenue recognition.

Question 9.4.70 in the Handbook provides additional background and guidance, including additional considerations for lessors.

Question 4.2.100

Build-to-suit applicability when an underlying asset is modified

Does the build-to-suit lease guidance apply when the underlying asset is modified after the commencement date?

Interpretive response: The build-to-suit guidance applies to 'underlying assets being constructed before the commencement date'. [842-40-55-5]

Therefore, we do not believe it applies when an underlying asset is modified after the commencement date unless the changes in effect create a *new* commencement date because the lessee loses control over the use of the asset while it is being modified or enhanced.

If the parties conclude that the build-to-suit guidance applies, they need to determine if the lessee is the accounting owner of the underlying asset being modified during the construction period of the modifications. Paragraph 9.4.70 and Question 9.4.50 in the Handbook provide guidance on evaluating whether the lessee is the accounting owner of an asset under construction.

And regardless of whether the build-to-suit guidance applies, the lessee and the lessor need to consider whether the changes to the underlying asset and/or

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other changes to the lease trigger a lease modification and, if so, account for that modification. See section 3.3 in this publication for lessor modification guidance.

Question 9.4.80 in the Handbook provides additional background and guidance.

Question 4.2.110

Identifying the underlying asset under construction

What constitutes the underlying asset under construction when an existing underlying asset is modified?

Interpretive response: If the asset modification meets the definition of an 'underlying asset' – i.e. the customer will obtain the right to use it once complete and it is physically distinct (see section 3.2.2 in the Handbook) – we believe the build-to-suit guidance applies only to the modification, and not to the pre-existing asset (see Question 4.2.100). [842 Glossary]

This is because the build-to-suit guidance explicitly applies to an 'underlying asset' being constructed before the commencement date. Therefore, if there are multiple underlying assets, each is its own unit of account for applying the build-to-suit guidance. [842-40-55-5]

When an asset modification meets the definition of an underlying asset on its own, the lessee and lessor will not, even if the lessee is determined to be the accounting owner of the modification, recognize and derecognize the original underlying asset, respectively.

Question 9.4.85 in the Handbook provides additional background and guidance, including examples of a warehouse modification and a manufacturing facility modification.

Question 4.2.120

Lease of to-be-constructed property improvements on land sold by the lessee to the lessor

Does a seller-lessee control property improvements under construction on land it has legally sold to the buyer-lessor if the land sale does not occur for accounting purposes until lease commencement?

Interpretive response: We do not believe the fact that the seller-lessee remains the accounting owner of the land during the building construction period (and therefore, does not derecognize it), in itself, means the seller-lessee controls the building being constructed on that land during that period.

This is because, despite the seller-lessee's continued *accounting* ownership of the land during the building construction period, *legal* ownership of the land has transferred. In addition, the seller-lessee has ceded control *over the land's use*

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to the buyer-lessor, consistent with the second part of paragraph 842-40-55-5(d), in perpetuity, beginning with the buyer-lessor's right to use the land to construct the building.

We do not believe this conclusion is affected by whether the transfer of the land is expected to meet the sale/purchase requirements in Subtopic 842-40 (see section 9.1 in the Handbook) at lease commencement.

Question 9.4.90 in the Handbook provides additional background.

4.3 Income taxes

Topic 842 does not contain tax accounting guidance, and only minor, conforming amendments to Topic 740 (income taxes) were made as part of ASU 2016-02. These amendments do not change the basic requirements of Topic 740.

The adoption of Topic 842 will likely affect an entity's calculation of deferred tax assets and liabilities even though tax laws may not be directly affected. The following changes will have the greatest effect on an entity's accounting for deferred taxes.

— For **lessees**, the recognition of ROU assets and lease liabilities for operating leases will require entities to recognize new deferred tax assets and deferred tax liabilities not previously recognized.

— For **lessors**, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets.

— For **seller-lessees** and **buyer-lessors** in sale-leaseback transactions, a failed sale or failed purchase could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.

A lessor classifies leases as operating, direct financing or sales-type leases for book purposes. For tax purposes, those leases are generally treated as true tax leases or as non-tax leases, which are similar to a sales transaction.

In a true tax lease, the lessor will be considered to own the asset for tax purposes and will deduct the depreciation for the asset and recognize taxable income for the rental income. In other jurisdictions and fact patterns, the lease may be treated as a non-tax lease for tax purposes. In this situation, the lessor will recognize a taxable gain or loss on the sale of the asset and will recognize interest income over the lease term for the financing provided to the lessee that is repaid through the payments under the lease.

The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessors.

Book classification	Tax classification	Primary impact of Topic 842
Operating	True tax lease	No significant change; amounts may vary
Operating	Non-tax lease	No significant change; amounts may vary

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Book classification	Tax classification	Primary impact of Topic 842
Sales-type	True tax lease	No significant change; amounts may vary
Sales-type	Non-tax lease	No significant change; amounts may vary
Direct financing	True tax lease	No significant change; amounts may vary
Direct financing	Non-tax lease	No significant change; amounts may vary[1]

Chapter 10 in the Handbook addresses income tax accounting. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Lease origination costs	Paragraphs 10.1.70–10.1.100
Lessor – direct financing lease for book and non-tax lease for tax	Example 10.1.30
Failed sale-leaseback for book and true tax leaseback for tax	Example 10.1.50
State and local income tax implications	Section 10.2
Change in US federal tax accounting method	Section 10.3
Transfer pricing	Section 10.4

Question 4.3.10#
Related party leases

Do deferred tax assets or liabilities arise in related party leases under Topic 842?

Interpretive response: Yes. Under Topic 842, a related party lease is accounted for based on its enforceable terms and conditions (or its written terms and conditions if the practical expedient outlined in section 1.2 is being applied). [842-10-55-12, 740-10-25-2(b)]

Question 10.1.10 in the Handbook provides additional guidance.

Question 4.3.20
Intercompany operating leases – REIT and taxable REIT subsidiary

Must a REIT retain its REIT subsidiary's deferred taxes on consolidation?

Background: In some REIT structures (e.g. hotel and some healthcare REITs), the REIT (parent company) owns a building and leases it under an operating

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lease to a REIT subsidiary (TRS) that either operates the property or contracts with a third party to operate the property.

The TRS accounts for the intercompany lease in its stand-alone financial statements as if it were a lease between unrelated parties. Because the TRS is taxed like a corporate entity, it provides deferred taxes in its ledger for the book/tax basis differences related to its ROU asset and lease liability. The deferred taxes are based on the TRS's applicable tax rate. [842-10-55-12]

Like the TRS, the REIT accounts for the intercompany lease in its stand-alone financial statements as if it were a lease between unrelated parties. However, because the REIT is effectively taxed at a zero rate, it does not provide deferred taxes in its ledger for its book/tax basis differences related to the lease.

The operating lease is eliminated in consolidation.

Interpretive response: No. We do not believe the REIT must retain (or provide) deferred taxes in the consolidated financial statements for the intercompany operating lease. [740-10-25-20]

Question 10.1.15 in the Handbook provides additional guidance.

4.4 Leases acquired in a business combination or asset acquisition

The following chart summarizes the acquirer's initial accounting at the acquisition date. The chart highlights the following. [805-20-25-10A, 25-12, 25-28A, 30-24 – 30-25]

- If the acquiree is a lessee, the same assets and liabilities are recognized regardless of whether the lease is an operating lease or a finance lease.
- If the acquiree is a lessor, the assets and liabilities recognized depend on whether the lease is an operating lease, or a sales-type or direct financing lease.
- In all cases, there may be one or more intangible assets related to the lease, such as a customer relationship, that must be recognized.

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Lease acquired in a business combination[1]			
Acquiree is lessee		**Acquiree is lessor**	
Operating and finance leases		**Operating leases**	**Sales-type and direct financing leases**
Lease liability[2] Present value of the remaining lease payments[3]	**ROU asset** Equal to the liability, adjusted for any favorable/ unfavorable terms[4]	**PP&E** Underlying asset at fair value	**Lease receivable** Present value of the remaining lease payments and guaranteed residual value[5]
Intangible assets Associated with the lease[8]		**Asset or liability** Favorable/ unfavorable terms[6]	**Unguaranteed residual asset** Difference between fair value of underlying asset[7] and lease receivable
		Intangible assets Associated with the lease[8]	

Notes:

1. The acquirer retains the acquiree's lease classification unless the lease is modified as part of the business combination, and that modification is not accounted for as a separate contract. [805-20-25-8, 842-10-55-11]
2. The lease liability (lessee) or lease receivable (lessor in a sales-type or direct financing lease) is measured as if the lease were a new lease at that date – i.e. as if the acquisition date were the lease commencement date. [805-20-30-24, 30-25(a)]
3. Discounted at the rate implicit in the lease if readily determinable, or otherwise using the *acquirer's* incremental borrowing rate. [805-20-30-24]
4. Renewal and/or purchase options that are either (1) favorable to the acquiree-lessee or (2) unfavorable to the acquiree-lessee but for which exercise is outside of the control of the acquiree-lessee (e.g. within the control of the lessor or an unrelated third party) affect the measurement of the ROU asset.
5. Discounted at the rate implicit in the lease. [805-20-30-25]
6. If a renewal option or a purchase option is unfavorable to the acquiree-lessor, a liability is recognized if exercise of the option is outside the lessor's control.
7. The terms and conditions of the lease are taken into account in determining the fair value of the underlying asset in a sales-type or direct financing lease.
8. Even if a lease is at market terms, there may be other identifiable intangible assets associated with the lease, such as an in-place lease asset or a customer relationship. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as an identifiable intangible asset. Such identifiable intangible assets are recognized at fair value in the acquisition accounting. [805-20-25-10A]

Both parties to a contract (the customer and the supplier) evaluate at inception of the contract whether it is or contains a lease. An entity does not reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6–15-7]

Prepaid or accrued rent (of lessees or lessors) is not recognized in the acquisition accounting because those amounts do not meet the definition of an

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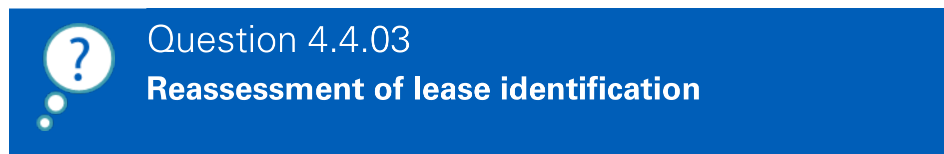
asset or a liability. Instead, the remaining lease payments affect whether the lease, as of the acquisition date, is at market terms. This means that if the lease payments are significantly front- or back-loaded, at the acquisition date this may result in a conclusion that the terms and conditions of the lease are off-market – e.g. because the remaining lease payments may be significantly less than or greater than the lease payments would be for a new lease with a term equal to the remaining lease term at the acquisition date. [ASU 2016-02.BC415]

Subsequent to the acquisition date, the acquirer applies the subsequent measurement guidance in Topic 842. The acquirer accounts for any intangible assets associated with the lease under Topic 350 (goodwill and other intangibles).

Leasehold (or tenant) improvements acquired are recognized at fair value and are amortized from the acquisition date over the shorter of the useful life of the leasehold improvements and the remaining 'lease term' at the date of acquisition.

Chapter 11 in the Handbook addresses leases acquired in a business combination or an asset acquisition. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Lease classification when acquirer's assessment of lease term or purchase option is different from acquiree's	Question 11.1.80
Subleases of an acquiree	Question 11.1.120
Favorability or unfavorability associated with a renewal option	Question 11.1.140
Measurement of acquired related party leases with off-market terms	Question 11.1.210**#**
Variable lease payments	Paragraph 11.1.60
Accounting for an acquired operating lease	Example 11.1.20
Accounting for an acquired finance/sales-type lease	Example 11.1.30
Comparison to legacy US GAAP	Paragraphs 11.1.120–11.1.180



Question 4.4.03

Reassessment of lease identification

When should an acquirer reassess lease identification in a business combination?

Interpretive response: We believe an acquirer should reassess the acquiree's lease identification conclusions only for acquired contracts whose terms and conditions are changed in connection with the transaction. [842-10-15-6]

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If lease identification is reassessed because of changed contractual terms and conditions, it is reassessed as of the acquisition date based on the changed terms and conditions of the contract.

Asset acquisitions

This view applies equally to leases acquired in an asset acquisition.

Acquiree assessments made in error

This interpretive response presumes that the acquiree's lease identification conclusions were appropriate. Topic 842 and Topic 805 do not grandfather accounting conclusions reached in error. Question 11.1.10 in the Handbook provides additional background and guidance and Example 11.1.10 illustrates this guidance.

Question 4.4.04

Acquiree assessment of lease classification or lease identification is not known or is not made under US GAAP

What should an entity do if it does not know the acquiree's lease classification or lease identification assessment or if those analyses were not performed under US GAAP?

Interpretive response: We believe it is necessary for the acquirer to assess the pre-acquisition lease classification or lease identification *as if it was the acquiree* – i.e. to determine what the acquiree's classification or lease identification assessment should have been, based on the acquiree's business and the facts and circumstances as of the date the acquiree should have undertaken that assessment.

Question 11.1.20 in the Handbook provides additional background and guidance.

Similarly, when an acquiree's accounting pre-acquisition is not under US GAAP (e.g. IFRS® Accounting Standards or GASB standards), the acquirer must convert it to US GAAP. Regardless of whether the transaction is a business combination or an asset acquisition, this includes (1) reassessing whether acquired contracts contain a lease (using the Topic 842 definition of a lease) and (2) reassessing lease classification conclusions reached by the acquiree under other US GAAP (using the Topic 842 classification criteria).

When this occurs, the acquirer will need to determine what the acquiree's lease identification assessment and lease classification would have been under Topic 842 based on the acquiree's business and the facts and circumstances as of the date the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.

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Question 4.4.05

Acquirer and acquiree adopted Topic 842 at different dates – reassessment of lease identification

If the acquiree's lease identification conclusion was reached under Topic 840, does the acquirer need to reassess that conclusion in a business combination or an asset acquisition?

Interpretive response: We are aware of multiple views about this question. In the absence of additional guidance from the FASB or the SEC staff, we believe the following views are acceptable.

View 1: Do not reassess any contracts for which the terms and conditions are not changed in connection with the transaction

Under this view, the different adoption dates for the acquirer and the acquiree are ignored when considering which contracts, if any, to reassess for lease identification. Consistent with our non-transition related response to Question 4.4.03 in this publication, the acquirer reassesses lease identification for existing acquiree contracts only if the terms and conditions of the contract are changed in connection with the transaction (assuming the acquiree's lease identification conclusions were not reached in error).

View 2: Reassess those contracts that would have been assessed by the acquirer under Topic 842, but were assessed by the acquiree under Topic 840

Under this view, the acquirer reassesses any contracts assessed for lease identification by the acquiree using the Topic 840 definition of a lease that would have been assessed by the acquiree using the Topic 842 definition of a lease if it had adopted Topic 842 on the same date as the acquirer. That reassessment is undertaken based on the acquiree's business and the facts and circumstances as of the date the acquiree should have undertaken it.

Which party, the acquirer or the acquiree, adopted Topic 842 first and the parties' transition elections can also affect how this view is applied.

Question 11.1.30 in the Handbook provides additional background and guidance. Example 11.1.10 in the Handbook illustrates the views outlined.

Question 4.4.06

Different acquirer and acquiree transition elections

Should an acquirer conform the acquiree's transition elections to its own in its business combination accounting?

Interpretive response: No. Accounting policies applicable to assets acquired and liabilities assumed from an acquiree generally should be conformed to those of the acquirer after a business combination (see chapter 7 of KPMG

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Handbook, Business combinations). However, we believe this applies only to ongoing accounting policies, and that an acquiree's valid, one-time transition elections when adopting Topic 842 are not accounting policies of the acquiree that must be conformed to those of the acquirer.

Notwithstanding this interpretive response, we do not believe there is guidance in Topic 842, Topic 805 or elsewhere in US GAAP that would *prohibit* an acquirer from treating the acquiree's transition elections as accounting policies to conform to its own. An acquirer's decision in this regard should be applied consistently.

Question 11.1.40 in the Handbook provides background and additional guidance.

Question 4.4.07

Only the acquirer or the acquiree has adopted Topic 842 – reassessment of lease identification

Does the acquirer need to reassess the acquiree's contracts for lease identification if the acquirer has adopted Topic 842 before the acquisition date, but the acquiree has not?

Interpretive response: We believe that the extent to which the acquirer needs to reassess the acquiree's Topic 840 lease identification conclusions (assuming that the terms and conditions of the lease have not changed in connection with the transaction and that the acquiree's lease identification assessments were appropriate) depends on whether the acquiree early adopts Topic 842 before the acquisition occurs.

Acquiree does not early adopt Topic 842

If the acquiree does not early adopt Topic 842 before the acquisition occurs, we believe the acquiree's accounting under Topic 840 is akin to a situation where the acquiree's accounting is under IFRS Accounting Standards or other GAAP that is not US GAAP (see Question 4.4.04).

Therefore, under this view, the acquirer reassesses all of the acquiree's contracts for lease identification using the Topic 842 definition of a lease as of the date that the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.

Acquiree early adopts Topic 842

Topic 842 permits early adoption (see sections 5.1 and 5.2 in this publication). Therefore, the acquiree could have early adopted Topic 842 immediately before the acquisition closes, *with retrospective effect to the beginning of its current fiscal year*. [842-10-65-1(b), 250-10-45-14]

The acquiree's transition elections (i.e. whether and which transition practical expedients were elected), which we believe the acquiree can make independent of what the acquirer chose for its own adoption (see Question 4.4.06), will affect which contracts the acquirer must reassess for lease identification.

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We believe that the acquirer can elect this approach regardless of whether the acquiree made its formal early adoption election before the acquisition date or after the acquisition has closed. However, regardless of when it is elected, the acquirer must follow through on all associated effects of the early adoption, including:

— reflecting such adoption in any stand-alone acquiree financial statements issued on or after the acquisition date; and
— making necessary disclosures about the acquiree's election in the acquirer's post-acquisition financial statements or other SEC filings.

Question 11.1.50 in the Handbook provides additional background and guidance.

Question 4.4.10

Lease classification when lease is modified in a business combination

Is the acquiree's lease classification reassessed when there is a lease modification in conjunction with a business combination?

Interpretive response: Yes. The classification of an acquired lease is reassessed if there is a lease modification enacted as part of the business combination and that modification is not accounted for as a separate contract. [842-10-55-11]

Question 11.1.60 in the Handbook provides additional guidance about when changes to a lease agreements are not lease modifications and whether to consider anticipated lease modifications.

Question 4.4.20

Acquiree's lease classification retained from Topic 840

Does the acquirer retain the acquiree's lease classification if it was determined by the lessee under Topic 840 and retained via the transition package of practical expedients in adopting Topic 842?

Interpretive response: Yes, unless the following applies:

— It is a business combination or acquisition of a not-for-profit entity and the lease is modified as part of the acquisition (and that modification is not accounted for as a separate contract). [842-10-55-11]
— It is an asset acquisition and one of the specific reassessment circumstances outlined in Question 4.4.30 occurs in connection therewith.

Question 11.1.70 in the Handbook provides additional background.

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Question 4.4.25

Reassessment of lease classification – only the acquirer has adopted Topic 842

Does the acquirer need to reassess the acquiree's lease classification if the acquirer has adopted Topic 842 before the acquisition date, but the acquiree has not?

Interpretive response:

Acquiree does not early adopt Topic 842

If the acquiree does not early adopt Topic 842 before the acquisition occurs, we believe the acquiree's accounting under Topic 840 is like a situation in which the acquiree's accounting is under IFRS Accounting Standards or other GAAP that is not US GAAP (see Question 11.1.95 in the Handbook).

Under this view, which treats Topic 840 like IFRS Accounting Standards or other local GAAP, the acquirer reassesses all of the acquiree's lease classification conclusions using the Topic 842 classification criteria as of the date that the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.

Acquiree early adopts Topic 842

Topic 842 permits early adoption (see sections 13A.1 and 13B.1). Therefore, the acquiree could have early adopted Topic 842 immediately before the acquisition closes, *with retrospective effect to the beginning of its current fiscal year*. The acquiree's transition elections affect whether the acquirer must reassess the acquiree's lease classification conclusions.

— If the transition package of practical expedients is elected by the acquiree, it would have conducted a lease classification assessment of its leases entered into or modified (and not meeting the Topic 842 criteria to be accounted for as separate contracts) on or after its early adoption effective date using the Topic 842 classification criteria. Consequently, those contracts are reassessed in accounting for the business combination because the acquiree had only assessed them under Topic 840. The acquirer does not need to reassess lease classification for leases that commenced before its early adoption effective date.

— If the transition package of practical expedients is not elected, all of the acquiree's leases are subject to classification reassessment using the Topic 842 classification criteria. This is because the acquiree would have been required to do so as part of its Topic 842 adoption.

We do not believe this approach is limited only to acquirees that made a formal election to early adopt before the acquisition date. Acquirees may have had no interim financial reporting or other requirement to make such an election in that timeframe. Instead, we believe this approach can be elected after the acquisition date. However, regardless of when it is elected – i.e. before or after the acquisition date – the acquirer must follow through on all associated effects of the early adoption. This includes, but is not limited to:

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— reflecting such adoption in any stand-alone acquiree financial statements issued on or after the acquisition date; and
— making necessary disclosures about the acquiree's election in the acquirer's post-acquisition financial statements or other SEC filings.

Question 11.1.75 in the Handbook provides additional background.

Question 4.4.30

Lease classification when lease is acquired in an asset acquisition

Is the classification of an existing lease reassessed when the lease is acquired in an asset acquisition?

Interpretive response: It depends. This is because under Topic 842 the classification of a lease is reassessed only in specific circumstances. These are when there is a: [842-10-25-1]

— lease modification not accounted for as a separate contract (*all entities*);

— change in the lease term (*lessees only*); or

— change in the assessment of whether a lessee is reasonably certain to exercise a purchase option (*lessees only*).

Absent one of these, lease classification is not reassessed. Therefore, acquisition of the lease alone would not result in reassessing lease classification. One of the above would have to occur in connection with the asset acquisition for lease classification to be reassessed.

Question 11.1.90 in the Handbook provides additional background and guidance.

Question 4.4.40

Accounting for leases acquired in an asset acquisition

How should lease assets and lease liabilities in an asset acquisition be accounted for?

Interpretive response: In an asset acquisition, in general, we believe the acquired leases should be accounted for in the same manner as they would be if they were acquired in a business combination – i.e. measured as if the lease were a new lease of the acquirer at the acquisition date.

However, because an entity does not recognize goodwill or a bargain purchase gain in an asset acquisition, the amounts recognized for the lease may be adjusted to relative fair value from what would have been recognized under Topic 805.

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Question 11.1.190 in the Handbook provides additional background and guidance.

Question 4.4.50

In-place leases

Does an in-place lease at the acquisition date create an intangible asset for the acquirer?

Interpretive response: Yes. We believe an acquirer should separately measure an intangible asset for in-place leases on a lease-by-lease basis.

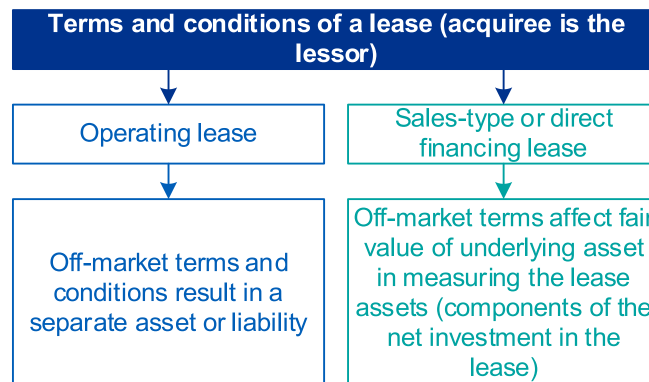
Question 11.1.110 in the Handbook provides additional background and guidance.

Question 4.4.60

Lease classification impact on the measurement of underlying assets

When the acquiree is the lessor, does the lease classification affect the measurement of the underlying asset's fair value in acquisition accounting?

Interpretive response: Yes. When the acquiree is the lessor, the terms and conditions of the lease affect the acquisition accounting differently depending on the lease classification. [805-20-30-25]



Question 11.1.150 in the Handbook provides additional guidance.

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Question 4.4.65

How off-market lease terms affect the fair value of the underlying asset in sales-type and direct financing leases

How do off-market terms affect the fair value of the underlying asset in a lessors' accounting for an acquired sales-type or direct financing lease?

Background: At the acquisition date, an acquirer lessor recognizes a lease receivable and an unguaranteed residual asset. Section 4.4 in this publication outlines how those amounts, totaling to the net investment in the acquired lease, are calculated, noting that: [805-20-30-25]

— the fair value of the underlying asset as of the acquisition date is a key input in measuring the newly acquired net investment in the lease and its components, the lease receivable and the unguaranteed residual asset; and
— the fair value of the underlying asset is affected by the terms and conditions of the acquired lease.

Neither Topic 805 nor Topic 842 explain or illustrate how to factor the terms and conditions of the acquired lease into the fair value of the underlying asset.

Interpretive response: The favorability or unfavorability of an acquired sales-type or direct financing lease results in an adjustment to the estimated fair value of the underlying asset, and consequently affects the measurement of the net investment in the lease (and its components, the lease receivable and the unguaranteed residual asset). This contrasts with an operating lease, where off-market terms result in separate recognition of a favorable lease asset or unfavorable lease liability.

This approach for acquired sales-type or direct financing leases means that the acquisition-date fair value of the acquired underlying asset will be higher or lower than the fair value of an equivalent asset sold in an orderly transaction between market participants; the difference is the amount by which the lease is off-market. The amount of that adjustment is calculated in the same manner as favorability/unfavorability is calculated for an operating lease.

Adjusting the fair value of the underlying asset affects the acquisition date measurement of the acquired lease receivable and acquired unguaranteed residual asset.

Off-market terms of an acquired sales-type or direct financing lease will result in the following acquisition-date accounting process for the acquirer related to that lease.

— **Step 1**: Determine the fair value of the underlying asset without considering the off-market terms of the acquired lease.

— **Step 2**: Calculate the off-market adjustment.

— **Step 3**: Adjust the fair value determined in Step 1 by the off-market adjustment calculated in Step 2.

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— **Step 4**: Measure the lease receivable, unguaranteed residual asset and net investment in the lease as outlined in the table earlier in section 4.4 of this publication.

Question 11.1.160 in the Handbook provides additional guidance on measuring the net investment in the lease and its components when the lease is off-market.

Question 4.4.70

Acquisition accounting for an acquired failed sale/purchase

How should an acquirer account for the failed sale or failed purchase of an acquiree in a sale-leaseback transaction?

Interpretive response: We believe the business combination does not eliminate the failed sale (if the acquiree is the seller-lessee) or the failed purchase (if the acquiree is the buyer-lessor).

The acquirer should continue with the failed sale/purchase accounting until the transaction meets the requirements in Subtopic 842-40 for a sale/purchase. The assets and liabilities of the acquiree related to the failed sale-leaseback transaction (e.g. the underlying asset and financial liability if the seller-lessee or the financial receivable if the buyer-lessor) are still subject to any appropriate adjustments to those assets and liabilities as required by Topic 805.

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Question 4.4.80

Different acquirer/acquiree separation of lease and non-lease component policy elections

Does an acquirer measure an acquired lease based on its accounting policy to separate or not separate lease and non-lease components if it differs from that of the acquiree?

Interpretive response: As outlined in chapter 7 of KPMG Handbook, Business combinations, accounting policies that apply to assets acquired and liabilities assumed from an acquiree generally should be conformed to those of the acquirer after a business combination. Therefore, we believe the acquirer should follow its own separation or non-separation accounting policy when *measuring* the acquired lease asset and/or liability, regardless of whether the acquiree was the lessee or the lessor in the lease.

However, an acquirer should *not* reassess the classification of the acquired lease in these circumstances, even though it might have differed had the acquiree been following the same separation or non-separation accounting policy as the acquirer. This is because, as outlined in section 4.4 (Note 1) and Question 4.4.10 in this publication, Topic 842 does not permit an acquiree to

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reassess the classification of an acquired lease unless the lease is modified in connection with the business combination (and that modification is not accounted for as a separate contract). [842-10-55-11]

Question 11.1.200 in the Handbook provides additional background.

4.5 Disclosures

The disclosure objective in Topic 842 is to provide financial statement users sufficient information to assess the amount, timing and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors disclose qualitative and quantitative information about lease transactions.

This generally will result in increased information being disclosed as compared to Topic 840. Accordingly, entities will need to evaluate whether they have appropriate systems, processes and internal controls to capture the complete and accurate lease data necessary to prepare the financial statement notes.

Chapter 12 in the Handbook addresses disclosures. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Chart of lease income for the reporting period	Example 12.3.10
Comparison to legacy US GAAP	Paragraph 12.3.20

Question 4.5.10
Interim disclosure requirements

Are the Topic 842 lease disclosures required for both interim and annual financial reporting periods after the year of adoption?

Interpretive response: No. The only disclosure requirement that applies to all interim periods is for *lessors* to disclose a table of lease income recognized during the period. However, the need for additional interim disclosures should be evaluated under the requirements of Topic 270. [842-30-50-5]

Question 12.1.10 in the Handbook provides additional guidance.

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Question 4.5.20
Annual disclosures in interim filings in the year of adoption

Are registrants required to provide all annual lease disclosures for each interim period in the year of adoption?

Interpretive response: Yes. While Topic 842 only requires certain lessor disclosures be made in all interim financial statements, Article 10 of Regulation S-X requires SEC registrants to provide both the annual and interim disclosures in each quarterly report in the year of adoption of a new accounting standard – i.e. the first, second and third quarter Form 10-Q filings. [Reg S-X, Article 10, FRM 1500]

Question 12.1.20 in the Handbook provides additional guidance.

Question 4.5.30
Assets subject to operating leases as a separate major class of depreciable asset

Are assets subject to operating leases a separate major class of depreciable assets?

Interpretive response: Yes. A lessor should treat assets subject to operating leases as a separate major class of depreciable assets, which should be further disaggregated by significant class of underlying assets (e.g. airplanes versus buildings). [ASU 2016-02.BC341]

Question 12.3.10 in the Handbook provides additional guidance.

Question 4.5.40
Separate disclosure of tenant reimbursements

Is a lessor that elected the lessor non-separation practical expedient permitted to separately disclose tenant reimbursements?

Background: Under Topic 840, lessors (particularly real estate lessors) frequently adopted a practice for net leases of presenting separately:

— revenue from the base rental payments due under a lease; and
— tenant reimbursements of lessor executory costs such as property taxes, insurance and maintenance (including common area maintenance).

As explained in Question 3.4.10, it is not acceptable for a lessor that has elected the non-separation practical expedient for lease and non-lease

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components to present these tenant reimbursements separately from base rental revenue in its income statement.

Consequently, the question arises about whether it is acceptable for the lessor to disclose the amount of tenant reimbursements it has included within lease revenue. For example, if a lessor recognizes lease revenue of $100 for the period, is it permitted to disclose that $16 of the $100 is from tenant reimbursements?

Interpretive response: In general, yes – provided that the lessor does not characterize the tenant reimbursements as a revenue measure, or present them in a manner that suggests they reflect payments for something other than, or in addition to, the right to use the underlying asset.

Therefore, in general, we believe separate presentation of such amounts should be labeled factually (e.g. as 'tenant reimbursements'), and shown and/or discussed as a component of the single lease revenue income statement line item – i.e. as an item that totals to lease revenue. Further, discussion of tenant reimbursements should be limited to disclosing facts, such as the dollar amount of property tax and/or insurance reimbursements billed to lessees that is included in the applicable income statement line item (e.g. lease revenue) for the period.

It would not be appropriate to characterize those amounts as anything other than a component of the single income statement line item. For example, we do not believe tenant reimbursements should be presented in a manner that suggests lease revenue or rental revenue includes only the base rent payments.

Doing so might inappropriately suggest a differentiation between the tenant reimbursements and base rent that is inconsistent with the fact that both amounts (the tenant reimbursements and the base rent) reflect payments for the right to use the underlying asset.

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5. Transition

Detailed contents

New item added in this edition: **

5.1 Effective date method

ASU 2023-01, Common Control Arrangements **

Questions

5.1.10 [Not used]

5.1.20 Issuance of a registration statement on Form S-3 after the effective date

5.1.30 Land easements arising before the effective date

5.1.40 Disclosures in comparative periods

5.1.45 Comparative periods

5.1.50 Combining lease and non-lease components in comparative periods – effective date method

5.2 Comparative method

ASU 2023-01, Common Control Arrangements **

Questions

5.2.10 [Not used]

5.2.20 Issuance of a registration statement on Form S-3 after the effective date

5.2.30 Land easements arising before the effective date

5.2.40 Disclosures in comparative periods

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5.1 Effective date method

In July 2018, the Board issued ASU 2018-11, Targeted Improvements, which provides optional transition relief by allowing companies to use the effective date of the leases standard as the date of initial application on transition – i.e. the 'effective date method'. Under this alternative transition method, the cumulative-effect adjustment to the opening balance of retained earnings is recognized on the date of adoption – e.g. January 1, 2022 for calendar year-end private companies that do not early adopt Topic 842.

Effective date information reflects the deferred effective dates provided by ASU 2020-05, Effective Dates for Certain Entities (Topic 606 and Topic 842).

Effective date:	Public business entities:[1] Annual and interim periods in fiscal years beginning after December 15, 2018.	Other entities: — Annual periods in fiscal years beginning after December 15, 2021 — Interim periods in fiscal years beginning after December 15, 2022.
Date of initial application:	The entity's effective date – i.e. the beginning of the reporting period in which Topic 842 is first applied. For a private company with a calendar year-end that does not early adopt Topic 842, this date will be January 1, 2022. The effective date and the date of initial application are the same under the effective date method.	
Early adoption:	All entities can adopt Topic 842 immediately.	
Transition method:	Modified retrospective, which requires a cumulative-effect adjustment to the opening balance of retained earnings on the effective date.	
Package of practical expedients (all or nothing):	An entity may elect not to reassess: — whether expired or existing contracts contain leases under the new definition of a lease; — lease classification for expired or existing leases; and — whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.	
Use of hindsight:	— Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised. — Elect on its own or with the package of practical expedients.	
Land easements:	— An entity may elect not to assess at transition whether any expired or existing land easements are, or contain, leases if they were not previously accounted for as leases under Topic 840. — Elect on its own or with the package of practical expedients and/or hindsight.	

Note:

1. This includes (1) 'public' not-for-profit entities (i.e. those that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market), with the exception of those entities that have not yet issued

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> financial statements under Topic 842 as described in the following paragraph, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.
>
> Public not-for-profit entities that have not issued (or made available for issuance) GAAP-compliant financial statements reflecting the adoption of Topic 842 as of June 3, 2020 must adopt Topic 842 for annual periods in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted.

When an entity elects the effective date method, it recognizes and measures all leases that exist at the effective date using a modified retrospective transition approach. The entity records a cumulative-effect adjustment as of the effective date. Comparative periods are presented under Topic 840 and do not include any retrospective adjustments to comparative periods to reflect the adoption of Topic 842. All leases that either (1) commence, or (2) are modified (where that modification is not accounted for as a separate contract) or remeasured on or after the effective date are accounted for under Topic 842. [842-10-65-1(c) – 65-1(d), 65-1(q), 65-1(t)]

As an exception, a lessee electing the recognition and measurement exemption for short-term leases (see section 6.3.1 in the Handbook) does not apply the transition requirements to those leases. [842-10-65-1(e)]

ASU 2018-20 Narrow-Scope Improvements for Lessors

ASU 2018-20 (issued December 10, 2018) enacted the following amendments to Topic 842:

- created a lessor-only practical expedient for sales and other similar taxes (see section 3.2 in this publication and paragraphs 7.3.210–7.3.240 in the Handbook);
- created accounting for lessor costs and lessee payments thereof that differs based on which party (lessee or lessor) remits payment for the cost to the relevant third party – e.g. the taxing authority or insurer (see section 3.2 in this publication and paragraphs 7.3.160–7.3.200 in the Handbook); and
- clarified that a lessor should recognize variable payments not included in the consideration in the contract as follows (see section 2.5 in this publication and section 4.4.3 in the Handbook):
  - the portion allocated to the separate lease component, in the period in which the changes in facts and circumstances on which the payment is based occur; and
  - the portion allocated to the non-lease component(s), as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

Entities that did not adopt Topic 842 before issuance of ASU 2018-20

Lessors that did not adopt Topic 842 before ASU 2018-20 was issued will adopt the amendments when they adopt Topic 842. The amendments will apply to all new and existing leases from the date of adoption – e.g. January 1, 2022 for a calendar year-end private company. [842-10-65-3(a)]

A lessor applying the effective date method is not required to recast its income statement presentation for periods before its adoption date (see

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Question 5.1.45 in this publication). Therefore, items may be presented differently in the adoption year than in comparative periods. The following are examples.

- A lessor may have historically presented sales tax collections from lessees on a gross basis in the income statement – i.e. separately from the associated tax cost. If the lessor elects the sales tax practical expedient on adopting Topic 842, it will present all sales tax collections on new and existing leases net of the related tax cost from the date of adoption.
- A lessor may have historically presented lessee reimbursements of property taxes or insurance net of the related costs. From the adoption date of Topic 842, for new and existing leases, it will present all property tax and insurance costs and lessee reimbursements thereof on a gross basis.

ASU 2019-01, Codification Improvements

ASU 2019-01 (issued March 5, 2019) enacted the following amendments to Topic 842:

- reinstated guidance from Topic 840 requiring lessors that are not manufacturers or dealers to measure the fair value of the underlying asset at its cost after reflecting any volume or trade discounts applied; cost includes acquisition costs such as sales taxes and delivery and installation costs. An exception arises if there is a significant time lapse between asset acquisition and lease commencement. In those cases, the lessor determines the fair value of the underlying asset under Topic 820 (fair value measurements); and [842-30-55-17A]

- requires lessors that are depository or lending institutions in the scope of Topic 942 (financial services – depository and lending) to classify the principal portion of lease payments received under sales-type or direct financing leases as cash flows from investing activities. The interest portion of those lease payments and all lease payments received under operating leases are classified as cash flows from operating activities. [842-30-45-5, 942-230-45-4]

The effective dates of the amendments in ASU 2019-01 are as follows. [842-10-65-4(a)]

Effective date	Public business entities[1]	Other entities
Annual periods – fiscal years beginning after	December 15, 2019	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2019	December 15, 2022
Early adoption allowed?	Yes	Yes

Note:

1. This includes (1) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market (with the exception of those entities that have not yet issued financial statements under Topic 842 as described in the following paragraph), and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

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> Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market that have not issued (or made available for issuance) financial statements reflecting the adoption of Topic 842 as of June 3, 2020 must adopt Topic 842 for annual periods in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted.

A lessor that does not adopt these amendments as of its Topic 842 adoption date applies them retrospectively from that date. For example, a calendar year-end public business entity lessor that adopts the amendments on January 1, 2020, retrospectively applies the amendments from its Topic 842 adoption date of January 1, 2019. [842-10-65-4(b)]

ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments

The amendments in ASU 2021-05 (issued July 19, 2021) require a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease if: [842-10-25-3A]

— the lease would have been classified as a sales-type lease or a direct financing lease under the pre-ASU classification criteria; and

— sales-type or direct financing classification would result in a commencement date loss.

The effective dates of the amendments in ASU 2021-05 are as follows. [842-10-65-5]

Effective date	Public business entities	Other entities
Annual periods – fiscal years beginning after	December 15, 2021	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2021	December 15, 2022
Early adoption allowed?	Yes, but not before adopting ASC 842.	

The available transition approaches depend on the entity's Topic 842 adoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021-05).

— **Lessors that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-05 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see sections 5.1 and 5.2 in this publication, respectively).

— **Lessors that have already adopted Topic 842** will apply the amendments in ASU 2021-05 either:

  – retrospectively to leases that commenced or were modified on or after the entity's adoption of Topic 842 (e.g. on January 1, 2019 for a calendar-year public business entity); or

  – prospectively to leases that commence or are modified (and that modification is not accounted for as a separate contract) after the entity adopts the ASU 2021-05 amendments.

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Additionally, Question 13A.4.40 in the Handbook provides guidance for entities that have already adopted Topic 842 and choose to apply the amendments in ASU 2021-05 prospectively.

ASU 2023-01, Common Control Arrangements**

ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under common control. Only the amendments related to the first of those two issues (**Issue 1**) applies to lessors.

The effective dates of the Issue 1 amendments in ASU 2023-01 are in the following table. [842-10-65-7]

Effective date	Private entities
Annual periods – fiscal years beginning after	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued	May adopt concurrent with Topic 842

The Issue 1 amendments permit a private entity (lessee or lessor) to elect a practical expedient to use the written terms and conditions, as opposed to the legally enforceable terms and conditions, of a common control leasing arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 1.2. [842-10-15-3A]

The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-7]

— **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the Issue 1 amendments in their first Topic 842 compliant financial statements and use the same transition method as they use to adopt the remainder of Topic 842 (i.e. the effective date method – for the comparative method, see section 5.2).

— **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the Issue 1 amendments:

  – prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the Issue 1

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amendments (e.g. January 1, 2024 if a calendar year entity that does not early adopt the amendments); or

– on a modified retrospective basis to all common control arrangements that still exist at the entity's adoption date of the Issue 1 amendments.

Under the modified retrospective transition approach, the entity records the effect of adopting the Issue 1 amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

Chapter 13A in the Handbook addresses the effective date method of transition. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Effective date for entities that are public business entities solely because their financial statements are included in an SEC filing	Question 13A.1.50
Effective date for an entity in the process of an initial public offering (IPO)	Question 13A.1.60**
Transition approach – modifications	Section 13A.2.2
Transition approach – practical expedients	Section 13A.2.3
Practical expedient – land easements	Paragraph 13A.2.130
Date of lease classification reassessment	Question 13A.2.20
Hindsight practical expedient	Questions 13A.2.30, 13A.2.90
Errors in applying Topic 842	Question 13A.2.100
Impact on initial direct costs for entities not electing the package of practical expedients	Paragraph 13A.2.140
Land easements	Paragraphs 13A.2.150–13A.2.200
Transition disclosures	Section 13A.2.5
Lessor elects package of practical expedients	Section 13A.4.1
Lessor does not elect package of practical expedients	Section 13A.4.2
Lessor guidance – practical expedient for separation of lease and non-lease components does not apply	Section 13A.5.2
Lessor guidance – practical expedient for separation of lease and non-lease components	Section 13A.5.3

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Sale-leaseback transactions	Section 13A.7
Previous business combinations	Section 13A.9

Question 5.1.20
Issuance of a registration statement on Form S-3 after the effective date

Does the reissuance of a registrant's financial statements in conjunction with filing a registration statement on Form S-3 change the date of initial application?

Interpretive response: No. The reissuance of the financial statements in the Form S-3 does not change the date of initial application from January 1, 2019 (for calendar year-end public business entities). [FRM 11210.1]

Question 13A.1.30 in the Handbook provides additional background and guidance.

Question 5.1.30
Land easements arising before the effective date

Can an entity change its accounting policy for land easements before the effective date of Topic 842?

Interpretive response: No. An entity that elects the optional transition practical expedient for land easements is required to continue to apply consistent accounting policies to new or modified contracts entered into before the effective date of Topic 842.

Question 13A.2.120 in the Handbook provides additional guidance, including which land easements are eligible for the practical expedient.

Question 5.1.40
Disclosures in comparative periods

Do the lessee, lessor and sale-leaseback disclosure requirements in Topic 842 apply to comparative periods presented in the post-adoption financial statements?

Interpretive response: No. Topic 842 disclosures are not required for comparative annual or interim periods ending before the effective date. However, previous disclosures required to be made under Topic 840 for those

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periods are required to be included in the entity's post-effective date financial statements.

Question 13A.2.130 in the Handbook provides additional guidance, including discussion about what disclosures an entity should include in comparative periods after the effective date.

Question 5.1.45
Comparative periods

Is a lessor permitted to recast comparative periods to conform to its Topic 842 gross vs net presentation?

Background: As discussed in section 3.2 in this publication and paragraph 13A.4.200 in the Handbook, some lessors may be required to change their presentation of lessor costs (e.g. property taxes) and lessee payments thereof on adopting Topic 842 from how they presented those items historically under Topic 840. This may create noticeable differences between a lessor's adoption year and comparative period financial statements.

Topic 840 and SEC guidance

Topic 840 does not prescribe gross or net presentation for lessor costs such as property taxes or insurance or lessee payments thereof, and there is no relevant SEC guidance.

Interpretive response: It depends. While Topic 842 would generally not permit recasting the comparative periods, Topic 250 (accounting changes and error corrections) may provide an avenue to do so.

Topic 842 does not permit recasting the comparative periods because, under the effective date method, Topic 842 does not apply before the effective date – i.e. it does not apply to the comparative periods presented. Recasting the comparative periods to, for example, separately present previously netted income statement amounts would, in effect, be selectively applying the comparative period method (see chapter 13B in the Handbook) to adopt the amendments in ASU 2018-20, while using the effective date method to adopt the remainder of Topic 842. [842-10-65-1(c)]

Although Topic 842 does not apply to the comparative periods presented when using the effective date transition method, Topic 250 may be considered. A change in gross versus net income statement presentation is a change in accounting principle under Topic 250. And because Topic 840 does not prescribe gross or net income statement presentation for lessor costs and lessee payments thereof, a lessor may be able to justify a change to its comparative periods' gross versus net income statement presentation to conform to its post-effective date presentation as preferable. An entity's facts and circumstances will affect whether or not such a change is preferable, and whether a preferability determination is required for the change. [250-10-45-2 – 45-8]

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Question 5.1.50

Combining lease and non-lease components in comparative periods

Is a lessor permitted to recast comparative periods to conform to its Topic 842 presentation of revenue from lease and qualifying non-lease components when using the effective date method of adoption?

Background: Many lessors have presented lease and non-lease revenue separately in their historical financial statements that they will account for as part of a combined component under Topic 842 because of the lessor non-separation practical expedient. For example, under Topic 840, a lessor may have presented lease revenue separately from revenue from operating or other substantial services in the income statement.

Additionally, under Topic 840, many lessors have presented base rent revenue separately from lease-related revenue arising from executory costs in the income statement. For example, a real estate lessor may have presented base rental revenue (i.e. from the minimum rental payments) separate from fixed CAM charges or variable tenant CAM reimbursements.

Because Topic 842 does not apply to periods before the date of adoption for lessors using the effective date method of transition (comparative periods remain subject to Topic 840), the question arises about whether a lessor using the effective date method is *permitted* to recast its income statement presentation for the comparative periods pre-Topic 842 adoption to conform to its combined presentation post-adoption. We believe it is clear that a lessor is not *required* to do so. [842-10-65-1(c)]

Topic 840 requires lease and non-lease (i.e. goods or substantial service) elements to be accounted for separately and there is no practical expedient that permits lessors to account for them on a combined basis. Topic 840 does not, however, provide guidance on how such lease and non-lease revenue must be presented in the income statement. [840-10-15-19]

However, SEC guidance in Regulation S-X requires issuer entities to present income from rentals (i.e. lease revenue) separately from sales and service revenue in the income statement. [Reg S-X, Rule 5-03(b)]

Interpretive response: Despite Topic 842 not applying to periods before the adoption date for lessors using the effective date method of transition, a lessor may still be permitted to do so. However, the specific lease and non-lease components for which it would be acceptable for a lessor to recast its comparative period income statement presentation differ if the lessor is an SEC registrant.

Non-SEC registrants

Topic 842 does not apply to the comparative periods presented when using the effective date method. Therefore, Topic 250 (accounting changes and error corrections) should be considered.

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We do not believe a change in income statement aggregation or disaggregation is a change in accounting principle under Topic 250 if both the previous and the new aggregations were acceptable under the applicable US GAAP – i.e. Topic 840 in this instance. And because Topic 840 does not specify separate or combined income statement presentation for the revenue items discussed in the background, we believe either was acceptable under Topic 840.

If a lessor changes its income statement aggregation for the comparative periods, the notes to the financial statements should disclose the change. We do not believe a preferability assessment under Topic 250 is required.

SEC registrants

We believe our response for non-SEC registrants also applies to SEC registrants if, and only if, the item presented separately from lease revenue was an executory cost element (e.g. maintenance, including CAM), rather than a non-lease element (i.e. goods or a substantial service), under Topic 840.

However, because of the guidance in SEC Regulation S-X applicable to SEC registrants, we do not believe income statement presentation of lease and non-lease goods or substantial service revenues on a combined basis was an acceptable accounting alternative for those lessors. Therefore, a lessor that is an SEC registrant is not permitted to change its comparative period income statements to combine revenues from leases and non-lease goods or substantial services.

We do not believe lessee payments of executory costs were required to be presented separately from lease revenue under Regulation S-X because Topic 840 characterizes those payments as part of 'those for the lease'.

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5.2 Comparative method

If an entity does not elect the effective date method permitted by ASU 2018-11, Topic 842 requires it to use a modified retrospective transition method. Entities that use the comparative method record the cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the earliest comparative period presented in the financial statements. From that date to the effective date, an entity applies the Topic 842 transition guidance to new and existing leases.

Effective date information reflects the deferred effective dates provided by ASU 2020-05, Effective Dates for Certain Entities (Topic 606 and Topic 842).

Effective date:	Public business entities:[1] Annual and interim periods in fiscal years beginning after December 15, 2018.	Other entities: — Annual periods in fiscal years beginning after December 15, 2021. — Interim periods in fiscal years beginning after December 15, 2022.
Date of initial application:	The beginning of the earliest period presented in the entity's first annual financial statements in which Topic 842 is applied. For a private company with a calendar year-end that does not early adopt	

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	Topic 842, this date will be January 1, 2021 if it presents two years.
Early adoption:	All entities can adopt Topic 842 immediately.
Transition method:	Modified retrospective, with application of the new guidance to all periods presented in the financial statements.
Transition date:	As referred to in this chapter, the date on which an entity applies the transition requirements to a lease that commences before the effective date or early adoption date, which is the later of: (1) the beginning of the earliest period presented in the financial statements in which Topic 842 is initially applied, or (2) the 'commencement date' for the lease (see section 5.1).
Package of practical expedients (all or nothing):	An entity may elect not to reassess: — whether expired or existing contracts contain leases under the new definition of a lease; — lease classification for expired or existing leases; and — whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.
Use of hindsight:	— Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised. — Elect on its own or with the package of practical expedients.
Land easements:	— May elect not to assess at transition whether any expired or existing land easements are, or contain, leases if they were not previously accounted for as leases under Topic 840. — Elect on its own or with the package of practical expedients and/or hindsight.

Note:

1. This includes (1) 'public' not-for-profit entities (i.e. those that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market), with the exception of those entities that have not yet issued financial statements under Topic 842 as described in the following paragraph, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

   Public not-for-profit entities that have not issued (or made available for issuance) GAAP-compliant financial statements reflecting the adoption of Topic 842 as of June 3, 2020 must adopt Topic 842 for annual periods in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted.

When an entity elects the comparative method, it recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. The entity records a cumulative-effect adjustment at the date of initial application. Comparative periods are presented in accordance with the transition period guidance in Topic 842. All leases that either (1) commence, or (2) are modified (where that modification is not accounted for as a separate contract) or remeasured on or after the effective date are accounted for under Topic 842. [842-10-65-1(c) – 65-1(d), 65-1(q), 65-1(t)]

As an exception, a lessee electing the recognition and measurement exemption for short-term leases does not apply the transition requirements to those leases. [842-10-65-1(e)]

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ASU 2018-20 Narrow-Scope Improvements for Lessors

ASU 2018-20 (issued December 10, 2018) enacted the following amendments to Topic 842:

- created a lessor-only practical expedient for sales and other similar taxes (see section 3.2 in this publication and paragraphs 7.3.210–7.3.240 in the Handbook);
- created accounting for lessor costs and lessee payments thereof that differs based on which party (lessee or lessor) remits payment for the cost to the relevant third party – e.g. the taxing authority or insurer (see section 3.2 in this publication and paragraphs 7.3.160–7.3.200 in the Handbook); and
- clarified that a lessor should recognize variable payments not included in the consideration in the contract as follows (see section 2.5 in this publication and section 4.4.3 in the Handbook):
  - the portion allocated to the separate lease component, in the period in which the changes in facts and circumstances on which the payment is based occur; and
  - the portion allocated to the non-lease component(s), as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

Entities that did not adopt Topic 842 before issuance of ASU 2018-20

Lessors that did not adopt Topic 842 before ASU 2018-20 was issued will adopt the amendments when they adopt Topic 842. The amendments will apply to all new and existing leases from the date of adoption – e.g. January 1, 2022 for a calendar year-end private company. [842-10-65-3(a)]

ASU 2019-01, Codification Improvements

ASU 2019-01 (issued March 5, 2019) enacted the following amendments to Topic 842:

- reinstated guidance from Topic 840 requiring lessors that are not manufacturers or dealers to measure the fair value of the underlying asset at its cost after reflecting any volume or trade discounts applied; cost includes acquisition costs such as sales taxes and delivery and installation costs. An exception arises if there is a significant time lapse between asset acquisition and lease commencement. In those cases, the lessor determines the fair value of the underlying asset under Topic 820 (fair value measurements); and [842-30-55-17A]
- requires lessors that are depository or lending institutions in the scope of Topic 942 (financial services – depository and lending) to classify the principal portion of lease payments received under sales-type or direct financing leases as cash flows from investing activities. The interest portion of those lease payments and all lease payments received under operating leases are classified as cash flows from operating activities. [842-30-45-5, 942-230-45-4]

The effective dates of the amendments in ASU 2019-01 are as follows. [842-10-65-4(a)]

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Effective date	Public business entities[1]	Other entities
Annual periods – fiscal years beginning after	December 15, 2019	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2019	December 15, 2022
Early adoption allowed?	Yes	Yes

Note:

1. This includes (1) 'public' not-for-profit entities (i.e. those that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market), with the exception of those entities that have not yet issued financial statements under Topic 842 as described in the following paragraph, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

   Public not-for-profit entities that have not issued (or made available for issuance) GAAP-compliant financial statements reflecting the adoption of Topic 842 as of June 3, 2020 must adopt Topic 842 for annual periods in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted.

On adoption, a lessor applies these amendments retrospectively from its date of initial application of Topic 842. For example, a calendar year-end public business entity lessor that adopts the amendments on January 1, 2020 retrospectively applies the amendments from its Topic 842 date of initial application of January 1, 2017. [842-10-65-4(b)]

ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments

The amendments in ASU 2021-05 (issued July 19, 2021) require a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease if: [842-10-25-3A]

— the lease would have been classified as a sales-type lease or a direct financing lease under the pre-ASU classification criteria; and

— sales-type or direct financing classification would result in a commencement date loss.

The effective dates of the amendments in ASU 2021-05 are as follows. [842-10-65-5]

Effective date	Public business entities	Other entities
Annual periods – fiscal years beginning after	December 15, 2021	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2021	December 15, 2022
Early adoption allowed?	Yes, but not before adopting ASC 842.	

The available transition approaches depend on the entity's Topic 842 adoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021-05).

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- **Lessors that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-05 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see sections 5.1 and 5.2 in this publication, respectively).
- **Lessors that have already adopted Topic 842** will apply the amendments in ASU 2021-05 either:
  - retrospectively to leases that commenced or were modified on or after the entity's adoption of Topic 842 (e.g. on January 1, 2019 for a calendar-year public business entity); or
  - prospectively to leases that commence or are modified (and that modification is not accounted for as a separate contract) after the entity adopts the ASU 2021-05 amendments.

*ASU 2023-01, Common Control Arrangements***

ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under common control. Only the amendments related to the first of those two issues (**Issue 1**) applies to lessors.

The effective dates of the Issue 1 amendments in ASU 2023-01 are in the following table [842-10-65-7]

Effective date	Private entities
Annual periods – fiscal years beginning after	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued	May adopt concurrent with Topic 842

The Issue 1 amendments permit a private entity to elect a practical expedient to use the written terms and conditions (as opposed to the legally enforceable terms and conditions) of a common control leasing arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 1.2. [842-10-15-3A]

The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-7]

- **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt

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the Issue 1 amendments in their first Topic 842 compliant financial statements and use the same transition method as they use to adopt the remainder of Topic 842 (i.e. the comparative method – for the effective date method, see section 5.1).

- **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the Issue 1 amendments:
  - prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the ASU (e.g. January 1, 2024 if a calendar year end entity that does not early adopt the amendments); or
  - on a modified retrospective basis to all common control arrangements that still exist at the entity's adoption date of the ASU.

  Under the modified retrospective transition approach, the entity records the effect of adopting the Issue 1 amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

  For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

Chapter 13B in the Handbook addresses the comparative method of transition. Specifically, the following additional guidance may be particularly relevant to real estate lessors.

Effects of adoption of Topic 842 by a successor entity on predecessor periods	Question 13B.1.40
Effective date for entities that are public business entities solely because their financial statements are included in an SEC filing	Question 13B.1.50
Effective date for an entity in the process of an initial public offering (IPO)	Question 13B.1.60**
Transition approach – modifications	Section 13B.2.2
Practical expedients	Section 13B.2.3
Date of lease classification reassessment	Question 13B.2.20
Hindsight practical expedient	Questions 13B.2.30, 13A.2.90
Errors in applying Topic 842	Question 13B.2.100
Impact on initial direct costs for entities not electing the package of practical expedients	Paragraph 13B.2.140
Land easements	Paragraphs 13B.2.150–13A.2.200

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Transition disclosures	Section 13B.2.5
Lessor elects package of practical expedients	Section 13B.4.1
Lessor does not elect package of practical expedients	Section 13B.4.2
Lessor guidance – practical expedient for separation of lease and non-lease components does not apply	Section 13B.5.2
Lessor guidance – practical expedient for separation of lease and non-lease components	Section 13B.5.3
Sale-leaseback transactions	Section 13B.7
Previous business combinations	Section 13B.9

Question 5.2.20

Issuance of a registration statement on Form S-3 after the effective date

Does the reissuance of a registrant's financial statements in conjunction with filing a registration statement on Form S-3 change the date of initial application?

Interpretive response: No. The reissuance of the financial statements in the Form S-3 does not change the date of initial application from January 1, 2017 (for calendar year-end public business entities). [FRM 11210.1]

Question 13B.1.30 in the Handbook provides additional background and guidance.

Question 5.2.30

Land easements arising before the effective date

Can an entity change its accounting policy for land easements before the effective date of Topic 842?

Interpretive response: No. An entity that elects the optional transition practical expedient for land easements is required to continue to apply consistent accounting policies to new or modified contracts entered into before the effective date of Topic 842.

Question 13B.2.120 in the Handbook provides additional guidance, including which land easements are eligible for the practical expedient.

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Question 5.2.40
Disclosures in comparative periods

Do the lessee, lessor and sale-leaseback disclosure requirements in Topic 842 apply to comparative periods presented in the post-adoption financial statements?

Interpretive response: Yes. Under the comparative method, the disclosure requirements apply to the comparative periods presented in the financial statements.

Question 13B.2.130 in the Handbook provides additional guidance, including discussion about what disclosures an entity should include in comparative periods after the effective date.

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Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions added in this edition are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #.

1. Scope and definition of a lease

1.2 Common Control Arrangements **

Question

1.2.45 Secondary use – building rooftop **

3. Lessor accounting

Question

3.3.05A Contract changes only affecting variable or contingent payments **

4. Other considerations

Questions

4.2.95 Accounting for the transfer of construction-in-progress in a build-to-suit scenario **

4.3.10 Related party leases #

5. Transition

5.1 Effective date method

ASU 2023-01, Common Control Arrangements **

5.2 Comparative method

ASU 2023-01, Common Control Arrangements **

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- Business combinations
- Climate risk in the financial statements
- Consolidation
- Credit impairment
- Debt and equity financing
- Derivatives and hedging
- Discontinued operations and held-for-sale disposal groups
- Earnings per share
- Employee benefits
- Equity method of accounting
- Fair value measurement
- Financial statement presentation
- Foreign currency
- GHG emissions reporting
- Going concern
- IFRS® compared to US GAAP
- Impairment of nonfinancial assets
- Income taxes
- Inventory
- Investments
- Leases
- Leases: Real estate lessors
- Long-duration contracts
- Reference rate reform
- Research and development
- Revenue recognition
- Revenue: Real estate
- Revenue: Software and SaaS
- Segment reporting
- Service concession arrangements
- Share-based payment
- Software and website costs
- Statement of cash flows
- Tax credits
- Transfers and servicing of financial assets

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