



EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: October 20, 2020

Comments Due: December 4, 2020

Leases (Topic 842)

Targeted Improvements

The Board issued this Exposure Draft to solicit public comment on proposed changes to Topic 842 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to “Technical Director, File Reference No. 2020-700, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until December 4, 2020. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing comments to director@fasb.org, File Reference No. 2020-700
- Sending a letter to “Technical Director, File Reference No. 2020-700, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

All comments received are part of the FASB's public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

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Proposed Accounting Standards Update

Leases (Topic 842)

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

On February 25, 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

As part of the Board's post-implementation review (PIR) of Topic 842, the Board and staff continue to assist stakeholders by responding to inquiries received and proactively seeking feedback on potential implementation issues that have arisen as public business entities began implementing Topic 842. Since the issuance of Update 2016-02, the Board has issued five Updates to assist stakeholders with implementation issues and two Updates deferring the effective date for private companies and certain not-for-profit organizations. Additionally, the FASB staff has responded to more than 275 technical inquiries during that time. Finally, the Board has provided a dedicated section on its website for PIR.

As part of the Board's PIR of Topic 842, the Board and staff continue to perform outreach with various stakeholder organizations to address any additional issues that may have arisen since the adoption of Topic 842 by public business entities. The amendments in this proposed Update include the following items brought to the Board's attention through those interactions with stakeholders:

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

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

Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease at lease commencement on the basis of specified classification criteria (see paragraph 842-10-25-2). Under Topic 842, a lessor is not permitted to estimate most variable payments and, thus, must exclude variable payments that are not estimated and do not depend on a reference index or a rate from the lease receivable. Subsequently, those excluded variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the lease receivable for a sales-type lease with variable payments that do not depend on a reference index or a rate of a certain magnitude may be less than the carrying amount of the underlying asset derecognized at lease commencement resulting in the lessor

recognizing a loss at lease commencement (hereinafter referred to as a day-one loss) even if the lessor expects the arrangement to be profitable overall.

Certain preparers and practitioners continue to highlight that recognizing an immediate loss for a sales-type lease with variable payments that do not depend on a reference index or a rate results in reporting outcomes that do not faithfully represent the underlying economics either at lease commencement or over the lease term. Those stakeholders emphasize that users of financial statements are not provided with financial information that is relevant or decision useful. Because lease arrangements with variable payment structures based on the performance or use of underlying assets are becoming more prevalent, particularly in the energy industry, stakeholders from that industry requested that the Board amend the leases guidance to address this issue.

Those stakeholders further highlighted that lessors did not recognize an immediate loss under Topic 840, *Leases*, because of the longstanding practice to account for leases with substantial variable payments as operating leases based on an interpretation of a classification criterion in Topic 840. That classification criterion was not retained in Topic 842.

The amendments in this proposed Update would address stakeholders' concerns by amending the lease classification requirements. Lessors would be required to classify and account for a lease with lease payments that are predominantly variable and do not depend on a reference index or a rate as an operating lease. When a lease is classified as operating, the lessor would not recognize a lease receivable, would not derecognize the underlying asset, and, therefore, would not recognize a selling profit or loss.

Issue 2: Option to Remeasure Lease Liability—Lessee Only

Topic 842 prohibits a lessee from remeasuring its lease liability solely for a change in a reference index or a rate upon which some or all of the variable lease payments are based. Rather, any change in future payments resulting from changes in a reference index or a rate is accounted for as a variable lease cost. Those variable lease costs are recognized in the period in which the obligation for those payments is incurred. Certain stakeholders expressed that because IFRS 16, *Leases*, requires a lessee to remeasure the lease liability in subsequent periods when a change to the lease payments resulting from a change in a reference index or a rate takes effect, precluding lessees from similar remeasurement of lease liabilities under Topic 842 has resulted in increased costs for dual reporting entities. In developing Topic 842, the Board recognized that remeasuring the lease liability provides the most updated information about a lessee's future cash obligations. Notwithstanding, the Board decided to prohibit that remeasurement because stakeholders' feedback indicated that the benefits of remeasuring a lease liability solely for changes in a reference index or a rate did not justify the costs associated with requiring that remeasurement.

Many preparers that issue financial statements in accordance with both generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) have noted that the differences in the requirements in Topic 842 and IFRS 16 create ongoing costs and complexity primarily because preparers are required to maintain separate lease payment analyses and schedules for GAAP and IFRS Standards reporting purposes. Those stakeholders also noted that the Board had recognized that remeasurement provides the most updated information and, therefore, requested that the Board amend the existing requirements in Topic 842 to permit (but not require) lessees to remeasure lease liabilities for changes in a reference index or a rate affecting future lease payments at the date that those changes take effect, consistent with the requirement in IFRS 16.

The amendments in this proposed Update would address stakeholders' concerns by providing lessees with the option to make an entity-wide accounting policy election to remeasure lease liabilities for changes in a reference index or a rate affecting future lease payments at the date that those changes take effect. By making this proposed amendment optional (rather than mandatory), each entity would be able to select the option that is most cost-effective for its particular circumstances. However, that option could affect the comparability of information for users of financial statements. An entity electing the option to remeasure lease liabilities for changes in a reference index or a rate affecting future lease payments would be required to disclose that fact.

Issue 3: Modifications Reducing the Scope of a Lease Contract

If a lease contract providing a lessee with the right to use multiple assets (for example, a master lease agreement) is modified such that certain of those rights are terminated early, Topic 842 requires that an entity (both lessees and lessors) reconsider the classification and adjust the accounting for the remaining lease components in that contract. This modification accounting is required regardless of whether those remaining lease components are economically affected by the early termination. In practice, an early termination could be executed either at or after the effective date of the modification (for example, because there is a notice period before a lessee can return the leased assets to the lessor).

Stakeholders questioned the appropriateness of requiring modification accounting for the remaining lease components if the early termination of one or more separate lease components does not economically affect the remaining lease components in that contract. Multiple preparers raised concerns that reassessing classification and adjusting the accounting for lease components that are economically unaffected by the termination of other lease components are burdensome and cause unjustified cost and complexity. Specifically, this accounting requires that an entity reconsider inputs for classification and measurement purposes, such as the economic life and fair value of the underlying asset and the discount rate. Additionally, stakeholders highlighted that reassessment of classification of economically unaffected remaining lease

components during the lease term could change lease classification (for example, lessors reclassifying a sales-type or direct financing lease to an operating lease) solely because of the passage of time. Those stakeholders asserted that those changes in classification could result in financial reporting that does not represent the economics of the arrangement.

Consequently, stakeholders requested that the Board amend the leases guidance to exempt entities from applying modification accounting to the remaining lease components within a lease contract when other lease components within the contract are terminated and those terminations do not affect the economics of the remaining components.

The amendments in this proposed Update would address stakeholders' concerns by exempting entities from applying modification accounting to the remaining lease components within a lease contract for transactions in which one or more lease components are terminated before the end of the lease term and that early termination does not economically affect the remaining lease components.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update on sales-type leases with variable payments would affect lessors. Specifically, the proposed amendments would affect lessors with lease contracts that have lease payments that are predominantly variable and do not depend on a reference index or a rate.

The amendments in this proposed Update on the option to remeasure the lease liability would affect lessees whose lease contracts have variable lease payments based on a reference index or a rate.

The amendments in this proposed Update on modifications that reduce the scope of a lease contract would affect both lessees and lessors that have lease contracts with multiple lease components. Specifically, the proposed amendments would affect both lessees and lessors when those contracts are amended to terminate one or more lease components without economically affecting the remaining lease components under those contracts.

What Are the Transition Requirements and When Would the Amendments Be Effective?

The amendments in this proposed Update would amend Topic 842, which has different effective dates for public business entities and entities other than public business entities. The Board will determine the effective date of the proposed amendments after considering stakeholders' feedback.

Entities that have not adopted Topic 842 on or before the effective date of a final Update would follow the transition requirements of Update 2016-02 (the original Update on leases) for all of the amendments in this proposed Update. This transition is either (a) retrospective to each prior period presented in the financial statements with the cumulative effect of transition recognized at the beginning of the earliest period presented or (b) retrospective to the beginning of the period of adoption with a cumulative effect of transition recognized at the beginning of the period of adoption.

For entities that have adopted Topic 842 before the effective date of a final Update, the transition would be as follows:

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

Early application would be allowed. Entities would be permitted to independently adopt and have separate transition methods for each issue within this proposed Update.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

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

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

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

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

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

Issue 2: Option to Remeasure Lease Liability—Lessee Only

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

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

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

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

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

Issue 3: Modifications Reducing the Scope of a Lease Contract

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

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

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

Transition

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

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

Amendments to the *FASB Accounting Standards Codification*[®]

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table summarizes the proposed amendments to the Accounting Standards Codification. The amendments are organized by area.

Area	Paragraphs
Issue 1: Sales-type leases with variable lease payments—Lessor only	3–6
Issue 2: Option to remeasure lease liability—Lessee only	7–10
Issue 3: Modifications reducing the scope of a lease contract	11–15

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–15. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

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

3. These amendments require that a lessor classify a lease with payments for the right to use the underlying asset that are predominantly variable lease payments and do not depend on a reference index or a rate as an operating lease.

Amendments to Master Glossary

4. Amend the Master Glossary term *Sales-Type Lease*, with a link to transition paragraph 842-10-65-5, as follows:

Sales-Type Lease

From the perspective of a **lessor**, a **lease** that meets one or more of the criteria in paragraph 842-10-25-2 and is not an operating lease in accordance with paragraph 842-10-25-3A.

Amendments to Subtopic 842-10

5. Amend paragraphs 842-10-15-42A and 842-10-25-2 and add paragraph 842-10-25-3A, with a link to transition paragraph 842-10-65-5, as follows:

Leases—Overall

Scope and Scope Exceptions

842-10-15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A ~~25-3~~.

Recognition

> Lease Classification

842-10-25-2 A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the **lease payments** and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When any of the criteria in this paragraph are met, a lessor shall apply the guidance in paragraph 842-10-25-3A to determine the classification of a lease with payments that are predominantly **variable lease payments** and do not depend on an index or a rate (such as the Consumer Price Index or a market interest rate).

842-10-25-3 When none of the criteria in paragraph 842-10-25-2 are met:

- a. A lessee shall classify the lease as an **operating lease**.
- b. A lessor shall classify the lease as either a **direct financing lease** or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:
 - 1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
 - 2. It is **probable** that the lessor will collect the lease payments plus any amount necessary to satisfy a **residual value guarantee**.

842-10-25-3A Notwithstanding whether any of the criteria in paragraph 842-10-25-2 are met, a lessor shall classify a lease with payments that are predominantly variable lease payments and do not depend on an index or a rate as an operating lease at lease commencement.

- 6. Add paragraph 842-10-65-5 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2020-XX, Leases (Topic 842): Targeted Improvements

842-10-65-5 The following represents the transition and effective date information related to sales-type leases with variable payments in Accounting Standards Update No. 2020-XX, Leases (Topic 842): Targeted Improvements:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph when it first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within those fiscal years. Early application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within fiscal years beginning after December 15, 202X (one year after annual period). Early application is permitted.
- d. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph by using one of the following two methods:
 - 1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraphs 842-10-25-8 through 25-8B.
 - 2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10-25-8 through 25-8B.
- e. An entity within the scope of (b) and (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2) and paragraph 250-10-50-3. An entity that elects the transition method in (d)(1) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.

Issue 2: Option to Remeasure Lease Liability—Lessee Only

7. The following amendments provide a lessee with an option to make an entity-wide accounting policy election to remeasure lease payments and lease liabilities for changes in a reference index or a rate on which future lease payments are based.

Amendments to Subtopic 842-10

8. Amend paragraphs 842-10-15-36, 842-10-35-4, and 842-10-55-231 and add paragraphs 842-10-35-4A and 842-10-55-231A, with a link to transition paragraph 842-10-65-6, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessee

842-10-15-35 The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the **lease term**:

- a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5
- b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the **commencement date**.

842-10-15-36 A lessee shall remeasure and reallocate the consideration in the contract upon either of the following:

- a. A remeasurement of the **lease liability** (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the **underlying asset**) (see paragraph paragraphs 842-20-35-4 through 35-4A)
- b. The effective date of a contract modification that is **does** not **meet the conditions in paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B** accounted for as a separate contract (see paragraph 842-10-25-8). **[Note: See Issue 3 for details on amendments related to modification accounting.]**

Subsequent Measurement

> Subsequent Measurement of the Lease Payments

842-10-35-4 A lessee shall remeasure the **lease payments** if any of the following occur:

- a. The **lease** is modified, and that modification ~~is does not accounted for as a separate contract~~ meet the conditions in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B. **[Note: See Issue 3 for details on amendments related to modification accounting.]**
- b. A contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the **lease term** are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the **underlying asset** becoming fixed payments for the remainder of the lease term. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the ~~{add glossary link}contract{add glossary link}~~ **{add glossary link}** are based does not constitute the resolution of a contingency subject to (b) (see ~~paragraph 842-10-35-5 paragraphs 842-10-35-4A through 35-5~~ for guidance on the remeasurement of variable lease payments that depend on an index or a rate).
- c. There is a change in any of the following:
 1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.
 2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.
 3. Amounts **probable** of being owed by the lessee under **residual value guarantees**. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

842-10-35-4A The guidance in paragraph 842-10-35-4(b) notwithstanding, a lessee that makes the election in paragraph 842-20-35-4A to remeasure the **lease liability** to reflect changes to variable lease payments resulting from a change in an index or a rate shall remeasure the lease liability only when the adjustment to the lease payments from the change in the index or rate takes effect.

Implementation Guidance and Illustrations

> Illustrations

> > Illustrations of Lessee Accounting for Variable Lease Payments

> > > Example 25—Variable Lease Payments That Depend on an Index or a Rate and Variable Lease Payments Linked to Performance

> > > > Case A—Variable Lease Payments That Depend on an Index or a Rate

842-10-55-226 Lessee enters into a 10-year lease of a building with annual lease payments of \$100,000, payable at the beginning of each year. The contract specifies that lease payments for each year will increase on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. This Example ignores any initial direct costs. The lease is classified as an operating lease.

842-10-55-227 The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 8 percent, which reflects the rate at which Lessee could borrow an amount equal to the lease payment in the same currency, over a similar term, and with similar collateral as in the lease.

842-10-55-228 At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at \$624,689 (the present value of 9 payments of \$100,000 discounted at the rate of 8 percent). The right-of-use asset is equal to the lease liability plus the prepaid rent (\$724,689).

842-10-55-229 Lessee prepares financial statements on an annual basis. Lessee determines the cost of the lease to be \$1 million (the total lease payments for the lease term). The annual lease expense to be recognized is \$100,000 (\$1 million ÷ 10 years).

842-10-55-230 At the end of the first year of the lease, the Consumer Price Index is 128. Lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be \$102,400 (\$100,000 × 128 ÷ 125).

842-10-55-231 Because Lessee has not remeasured the lease liability for another reason and has not made the election in paragraph 842-20-35-4A to remeasure

the lease liability to reflect changes to variable lease payments resulting from a change in an index or a rate, Lessee does not make an adjustment to the lease liability to reflect the Consumer Price Index at the end of the reporting period; that is, the lease liability continues to reflect annual lease payments of \$100,000 (8 remaining annual payments of \$100,000, discounted at the rate of 8 percent is \$574,664). However, the Year 2 payment amount of \$102,400 (the \$100,000 annual fixed payment + \$2,400 variable lease payment) will be recognized in profit or loss for Year 2 of the lease and classified as cash flow from operations in Lessee's statement of cash flows. In its quantitative disclosures, Lessee will include \$100,000 of the \$102,400 in its disclosure of operating lease cost and \$2,400 in its disclosure of variable lease cost. In its maturity analysis of its operating lease liability, Lessee will include \$100,000 as the undiscounted cash flows from the lease (see paragraph 842-20-50-6).

842-10-55-231A If Lessee has made the election in paragraph 842-20-35-4A to remeasure the lease liability to reflect changes to variable lease payments resulting from a change in an index or a rate, Lessee remeasures the lease liability at the beginning of Year 2 (the date at which the change in payments takes effect). That remeasurement would reflect the Consumer Price Index at the end of Year 1, which is the basis for the lease payment to be made on the first day of Year 2. After Lessee makes the lease payment at the beginning of Year 2, the lease liability is remeasured to reflect annual lease payments of \$102,400 with a corresponding adjustment to the right-of-use asset (8 remaining annual payments of \$102,400, discounted at the rate of 8 percent is \$588,456). In its quantitative disclosures for Year 2, Lessee will include \$102,400 in its disclosure of operating lease cost. In its maturity analysis of its operating lease liability, Lessee will include \$102,400 as the undiscounted cash flows from the lease (see paragraph 842-20-50-6).

Amendments to Subtopic 842-20

9. Amend paragraphs 842-20-35-4 and 842-20-35-7 and add paragraphs 842-20-35-4A and 842-20-50-10, with a link to transition paragraph 842-10-65-6, as follows:

Leases—Lessee

Subsequent Measurement

> Remeasurement of the Lease Liability

842-20-35-4 After the **commencement date**, a **lessee** shall remeasure the **lease liability** to reflect changes to the **lease payments** as described in paragraphs 842-10-35-4 and 842-10-35-5 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the **right-of-use asset**. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

842-20-35-4A A lessee may, as an accounting policy election for all **leases**, remeasure the lease liability to reflect changes to **variable lease payments** resulting from a change in an index or a rate upon which those payments are based. A lessee shall recognize the amount of the remeasurement of the lease liability when the adjustment to the lease payments resulting from the change in index or rate takes effect as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in earnings. In applying the remeasurement requirements in this paragraph (that is, solely for changes to the variable lease payments resulting from a change in an index or a rate), a lessee shall not update the **discount rate for the lease** at the date of remeasurement unless the change in lease payments results from a change in floating interest rates. In that case, a lessee shall use a revised discount rate that reflects changes in the interest rate.

> Amortization of the Right-of-Use Asset for a Finance Lease

842-20-35-7 A lessee shall amortize the **right-of-use asset** on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. When the **lease liability** is remeasured and the right-of-use asset is adjusted in accordance with paragraph 842-20-35-4 or 842-20-35-4A, amortization of the right-of-use asset shall be adjusted prospectively from the date of remeasurement.

Disclosure

842-20-50-10 A lessee that elects to remeasure its lease liabilities in accordance with paragraph 842-20-35-4A to reflect changes to variable lease payments resulting from a change in an index or a rate shall disclose that fact.

10. Add paragraph 842-10-65-6 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2020-XX, Leases (Topic 842): Targeted Improvements

842-10-65-6 The following represents the transition and effective date information related to the option for lessees to remeasure lease liabilities in Accounting Standards Update No. 2020-XX, Leases (Topic 842): Targeted Improvements:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within those fiscal years. Early application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within fiscal years beginning after December 15, 202X (one year after annual period). Early application is permitted.
- d. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using one of the following two methods:
 - 1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, an entity shall apply the pending content that links to this paragraph to leases that exist at or commence on or after the beginning of the period of adoption of Topic 842.
 - 2. Prospectively to leases that exist at or commence on or after the date the entity first applies the pending content that links to this paragraph.
- e. An entity within the scope of (b) and (c) shall provide the applicable transition disclosures required by Topic 250, except for the requirements in paragraph 250-10-50-1(b)(2) and paragraph 250-10-50-3. An entity that elects the transition method in (d)(1) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.

Issue 3: Modifications Reducing the Scope of a Lease Contract

11. The following amendments provide that an entity would not apply modification accounting to the remaining lease components in a lease contract upon the early termination of one or more lease components in that lease contract if certain criteria are met (for example, the total payments for the remaining lease components are substantially the same as before the reduction in scope of that lease contract).

Amendments to Subtopic 842-10

12. Amend paragraphs 842-10-15-40 through 15-41, 842-10-25-1, 842-10-25-9, 842-10-25-11, 842-10-25-13, 842-10-25-15 through 25-17, 842-10-35-3, 842-10-35-6, 842-10-55-11, 842-10-55-177, 842-10-55-186, and 842-10-55-247 and add paragraphs 842-10-25-8A through 25-8C, with a link to transition paragraph 842-10-65-7, as follows:

Leases—Overall

Scope and Scope Exceptions

> Separating Components of a Contract

> > Lessor

842-10-15-40 If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall not recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the **lessee's** sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for ~~as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8C~~ unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).

842-10-15-41 A lessor shall remeasure and reallocate the remaining consideration in the contract when there is a contract modification that ~~is~~ does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B.

Recognition

> Lease Classification

842-10-25-1 An entity shall classify each separate **lease** component at the **commencement date**. An entity shall not reassess the lease classification after the commencement date unless the **contract** is modified and the modification ~~is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B.~~ In addition, a **lessee** also shall reassess the lease classification after the commencement date if there is a change in the **lease term** or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the **underlying asset**. When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for example, on the basis of the **fair value** and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset or as of the effective date of a modification ~~that does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B).~~

> Lease Modifications

842-10-25-8 An entity shall account for a modification to a **contract** as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

- a. The modification grants the **lessee** an additional right of use not included in the original **lease** (for example, the right to use an additional asset).
- b. The **lease payments** increase commensurate with the **standalone price** for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a **lessor** to incur costs that it would have incurred for a new lessee.

842-10-25-8A A contract that conveys the rights to use multiple **underlying assets** that comprise more than one separate lease component in accordance with paragraphs 842-10-15-28 through 15-29 (for example, a master lease agreement) could be modified to terminate the rights to use one or more but not all of the underlying assets. The termination date may coincide with or follow the **effective date of the modification**. If a modification does not meet the conditions in paragraph 842-10-25-8B, an entity shall apply the guidance in paragraphs 842-10-25-9 through 25-18 to the contract.

842-10-25-8B When the termination of one or more separate lease components before the end of the **lease term** does not affect the remaining lease component(s) subject to the contract, an entity (a lessee or a lessor) shall not reassess the classification of or adjust its accounting for the remaining lease component(s). The early termination of one or more separate lease components does not affect the remaining lease component(s) when all of the following conditions are met:

- a. The terms and conditions other than those that relate to the total payments applicable to the remaining lease component(s) are not changed. For changes associated with total payments, see paragraph 842-10-25-8B(c).
- b. The termination of the lease component(s) does not result in a change to the lease term for the remaining lease component(s) including no changes to:
 1. The noncancellable period of the lease term for a remaining lease component(s). For example, the noncancellable period of the lease term for a remaining lease component may change because a termination penalty in a master lease agreement may become significant for that remaining lease component even if the early termination of another lease component within that contract is at its commensurate price.
 2. An entity's assessment of whether the lessee is reasonably certain to exercise a renewal or termination option or a purchase option in the contract for the remaining lease component(s).
See paragraphs 842-10-30-1 through 30-4, 842-10-35-1 through 35-3, and 842-10-55-23 for guidance on lease term.
- c. The total payments for the remaining lease component(s) over the lease term are substantially the same as those required by the contract before the effective date of the modification. Those payments shall include any payments made as a result of the modification (for example, termination penalties) but exclude the following payments made by the lessee instead of returning the underlying asset(s) subject to the terminated lease component(s) to the lessor:
 1. The purchase of the underlying asset(s) subject to the terminated lease component(s) in accordance with the terms and conditions of the contract or at the fair value of the asset(s) at the date of purchase

2. A casualty loss associated with the underlying asset(s) subject to the terminated lease component(s) in accordance with the terms and conditions of the contract or at the fair value of the asset(s) at the date of termination.

842-10-25-8C When the early termination of one or more lease component(s) does not affect the remaining lease component(s) (that is, the remaining lease component(s) are accounted for in accordance with paragraph 842-10-25-8B), an entity shall account for the modified lease component(s) that are terminated early as follows:

- a. When the termination date for one or more lease component(s) is at the effective date of the modification, an entity shall account for the modified lease component(s) by applying the derecognition requirements in paragraph 842-20-40-1 for a lessee and paragraph 842-30-40-2 for a lessor at the date of termination.
- b. When the termination date for one or more lease component(s) is after the effective date of the modification (for example, because of a notice period required before termination), an entity shall account for the modified lease component(s) in the following manner:
 1. A lessee or a lessor shall remeasure and reallocate the remaining consideration in the contract for the modified lease component(s) to those component(s).
 2. A lessee or a lessor shall reassess the classification of the modified lease component(s) in accordance with paragraph 842-10-25-1 as of the effective date of the modification.
 3. A lessee shall remeasure the **lease liability** for the modified lease component(s) using a **discount rate for the lease** determined at the effective date of the modification and recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding **right-of-use asset**. A lessor shall apply the guidance in paragraphs 842-10-25-15 through 25-18 to account for the lease component(s) that are modified for an early termination.

842-10-25-9 If a lease is modified and that modification ~~is~~ does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B, the entity shall reassess the classification of the lease in accordance with paragraph 842-10-25-1 as of the **{remove glossary link}effective date of the modification{remove glossary link}**.

842-10-25-10 An entity shall account for **initial direct costs**, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

> > Lessee

842-10-25-11 A lessee shall reallocate the remaining **consideration in the contract** and remeasure the **lease liability** using a **discount rate for the lease** determined at the **effective date of the modification** if a contract modification does any of the following:

- a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8)
- b. Extends or reduces the term of an existing **lease** (for example, changes the **lease term** from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5)
- c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease) and does not meet the conditions in paragraphs 842-10-25-8A through 25-8B
- d. Changes the consideration in the contract only.

842-10-25-12 In the case of (a), (b), or (d) in paragraph 842-10-25-11, the lessee shall recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding **right-of-use asset**.

842-10-25-13 In the case of (c) in paragraph 842-10-25-11, the lessee shall remeasure the right-of-use asset and recognize a gain or a loss, if any, as follows:

- a. For a full or partial termination of a lease contract that contains a single lease component, the lessee shall decrease the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset shall be recognized as a gain or a loss at the effective date of the modification.
- b. For a partial termination of a lease contract that contains more than one lease component and does not meet the conditions in paragraph 842-10-25-8B, the lessee shall:
 1. Recognize the amount of the remeasurement of the lease liability for the remaining lease component(s) as an adjustment to the corresponding right-of-use asset
 2. Apply the derecognition requirements in paragraph 842-20-40-1 to the terminated lease component(s) at the termination date.

842-10-25-14 If a **finance lease** is modified and the modified lease is classified as an **operating lease**, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in

paragraph 842-20-30-5 to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

> > Lessor

842-10-25-15 If an **operating lease** is modified and the modification is ~~does~~ not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B, the **lessor** shall account for the modification as if it were a termination of the existing **lease** and the creation of a new lease that commences on the **effective date of the modification** as follows:

- a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the **lease payments** for the modified lease.
- b. If the modified lease is classified as a **direct financing lease** or a **sales-type lease**, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the **selling profit or selling loss** accordingly.

842-10-25-16 If a direct financing lease is modified and the modification is ~~does~~ not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
- b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the **commencement date** of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the **fair value of the underlying asset** is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
- c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

842-10-25-17 If a sales-type lease is modified and the modification is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)
- b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).

842-10-25-18 See Examples 15 through 22 (paragraphs 842-10-55-159 through 55-209) for illustrations of the requirements on **lease modifications**.

Subsequent Measurement

> Lease Term and Purchase Options

842-10-35-3 A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B. When a lessee exercises an option to extend the lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise or exercises an option to terminate the lease that the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

> Subsequent Measurement of the Lease Payments

842-10-35-6 A **lessor** shall not remeasure the lease payments unless the lease is modified and that modification is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B.

Implementation Guidance and Illustrations

> Implementation Guidance

> > Lease Classification

> > > Lease of an Acquiree

842-10-55-11 In a **business combination** or an **acquisition by a not-for-profit entity**, the acquiring entity should retain the previous **lease** classification in accordance with this Subtopic unless there is a **lease modification** and that modification ~~is does not meet the conditions~~ accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B.

> Illustrations

> > Illustrations of Lease Modifications

> > > Lessee

> > > > Example 18—Modification That Decreases the Scope of a Lease

842-10-55-177 Lessee enters into a 10-year lease for 10,000 square feet of office space. On the basis of facts and circumstances, Lessee determines at lease commencement that the 10,000 square-foot space is a single lease component. The annual lease payment is initially \$100,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee does not provide a residual value guarantee. The lease does not transfer ownership of the office space to Lessee or grant Lessee an option to purchase the space. The lease is an operating lease for all of the following reasons:

- a. The lease term is 10 years, while the office building has a remaining economic life of 40 years.
- b. The fair value of the office space is estimated to be significantly in excess of the present value of the lease payments.
- c. The office space is expected to have an alternative use to Lessor at the end of the lease term.

842-10-55-178 At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease to only 5,000 square feet of the original space and to reduce the annual lease payment to \$68,000. That amount will increase 5 percent each year thereafter of the remaining lease term.

> > > > Example 19—Modification That Changes the Lease Payments Only

842-10-55-186 Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are \$95,000 in Year 1, paid in arrears, and increase by \$1,000 every year thereafter. The original discount rate for the lease is 6 percent. The lease is an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease payments by \$7,000 each year (that is, the lease payments will be \$93,000

in Year 6 and will continue to increase by \$1,000 every year thereafter). The modification only changes the lease payments and, therefore, cannot meet the conditions in paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B ~~be accounted for as a separate contract~~. The classification of the lease does not change as a result of the modification.

> > Illustrations of Transition

> > > Illustration of Lessee Transition—Existing Capital Lease

> > > > Example 28—Lessee Transition—Existing Capital Lease

842-10-55-247 Beginning on the effective date, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements, except for the requirement to reassess amounts probable of being owed under residual value guarantees. Such amounts will only be reassessed if there is a remeasurement of the lease liability for another reason, including as a result of a lease modification (that is, does not meet the conditions in paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B ~~accounted for as a separate contract~~).

Amendments to Subtopic 842-10

13. Amend paragraph 842-10-65-1 and its related heading, with no link to a transition paragraph, as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842*, *Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, No. 2019-01, *Leases (Topic 842): Codification Improvements*, No. 2019-10, *Financial Instruments—Credit Losses (Topic 326)*, *Derivatives and Hedging (Topic 815)*, and *Leases (Topic 842): Effective Dates*, and No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, and No. 2020-XX, *Leases (Topic 842): Targeted Improvements*

842-10-65-1 The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842*, *Leases*, No.

2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, No. 2019-01, *Leases (Topic 842): Codification Improvements*, No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, and No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, and No. 2020-XX, *Leases (Topic 842): Targeted Improvements*; [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

Lessees

Leases previously classified as operating leases under Topic 840

- I. Unless, on or after the effective date, the lease is modified (and that modification ~~is does not meet the conditions accounted for as a separate contract in accordance with~~ paragraph 842-10-25-8 ~~or paragraphs 842-10-25-8A through 25-8B~~) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a **discount rate for the lease** (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the application date as determined in (c):
 1. The remaining minimum rental payments (as defined under Topic 840).
 2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.
- q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not meet the conditions result in a separate contract in accordance with paragraph 842-10-25-8 ~~or paragraphs 842-10-25-8A through 25-8B~~, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 and ~~842-20-35-5 through 35-5~~), the lessee shall follow the requirements in this Topic from the **effective date of the modification** or the remeasurement date.

Leases previously classified as capital leases under Topic 840

- t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not ~~result in a separate contract meet the conditions in accordance with~~ paragraph 842-10-25-8 ~~or paragraphs 842-10-25-8A through 25-8B~~, or the lessee is required to remeasure the lease liability in accordance with ~~paragraph paragraphs~~ 842-20-35-4 ~~and 842-20-35-5~~, the lessee shall subsequently account for

the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

Lessors

Leases previously classified as direct financing or sales-type leases under Topic 840

- x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:
 - 1. Continue to recognize a net investment in the lease at the application date as determined in (c) at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with Topic 840.
 - 2. If an entity elects the transition method in (c)(1), before the effective date, a lessor shall account for the lease in accordance with Topic 840.
 - 3. Regardless of the transition method selected in (c), beginning on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance in Subtopic 842-30.
 - 4. Beginning on the effective date, if a lessor modifies the lease (and the modification ~~is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B~~), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the lease is classified as a direct financing lease before the modification or paragraph 842-10-25-17 if the lease is classified as a sales-type lease before the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification ~~is does not meet the conditions accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B~~).

[Subparagraphs a–k, m–p, r–s, u–w, and y–ee are not included here because they are unchanged.]

Amendments to Subtopic 842-30

- 14. Amend paragraphs 842-30-35-2, with a link to transition paragraph 842-10-65-6, as follows:

Leases—Lessor

Subsequent Measurement

> Sales-Type and Direct Financing Leases

842-30-35-2 After the commencement date, a lessor shall not remeasure the net investment in the lease unless the ~~lease~~ is modified and that modification ~~is~~ does not ~~meet the conditions~~ accounted for as a separate contract in accordance with paragraph 842-10-25-8 or paragraphs 842-10-25-8A through 25-8B.

15. Add paragraph 842-10-65-7 and its related heading as follows:

Leases—Overall

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2020-XX, Leases (Topic 842): Targeted Improvements

842-10-65-7 The following represents the transition and effective date information related to modifications reducing the scope of a lease contract in Accounting Standards Update No. 2020-XX, *Leases (Topic 842): Targeted Improvements*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within those fiscal years. Early application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 202X [date to be inserted after exposure], and interim periods within fiscal years beginning after December 15, 202X (one year after annual period). Early application is permitted.
- d. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using one of the following two methods:
 1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, an entity shall

- apply the pending content that links to this paragraph to leases that are modified on or after the beginning of the period of adoption.
2. Prospectively to leases that are modified on or after the date the entity first applies the pending content that links to this paragraph.
- e. An entity within the scope of (b) and (c) shall provide the applicable transition disclosures required by Topic 250, except for the requirements in paragraph 250-10-50-1(b)(2) and paragraph 250-10-50-3. An entity that elects the transition method in (d)(1) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board.

Members of the Financial Accounting Standards Board:

Richard R. Jones, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Susan M. Cosper
Marsha L. Hunt
R. Harold Schroeder

Background Information and Basis for Conclusions

Introduction and Background

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. On February 25, 2016, the Board issued Update 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions.

BC3. As part of the Board's PIR of Topic 842, the Board and staff continue to assist stakeholders by responding to inquiries received and proactively seeking feedback on potential implementation issues that have arisen as public business entities began implementing Topic 842. Since the issuance of Update 2016-02, the Board has issued five Updates to assist stakeholders with implementation issues and two Updates deferring the effective date for private companies and certain not-for-profit organizations. Additionally, the FASB staff has responded to more than 275 technical inquiries during that time. Finally, the Board has provided a dedicated section on its website for PIR.

BC4. As part of the Board's PIR of Topic 842, the Board and staff continue to perform outreach with various stakeholder organizations to address any additional issues that may have arisen since the adoption of Topic 842 by public business entities. The amendments in this proposed Update include the following items brought to the Board's attention through those interactions with stakeholders:

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

A discussion of these issues and the basis for conclusions reached by the Board for addressing those issues are provided below.

Benefits and Costs

BC5. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and

other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC6. Overall, the Board decided that the amendments in this proposed Update would simplify the implementation and ongoing application of Topic 842 for preparers and would either improve or maintain the decision usefulness of information provided to present and potential investors, creditors, donors, and other users. Further discussion of the costs and benefits of the amendments in this proposed Update is provided below.

Basis for Conclusions

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

BC7. Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease at lease commencement on the basis of specified classification criteria (see paragraph 842-10-25-2). Under Topic 842, a lessor is not permitted to estimate most variable payments and, thus, must exclude variable payments that are not estimated and do not depend on a reference index or a rate from the lease receivable. Subsequently, those variable payments are recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. Consequently, the lease receivable for a sales-type lease with variable payments that do not depend on a reference index or a rate of a certain magnitude may be less than the carrying amount of the underlying asset derecognized at lease commencement resulting in the lessor recognizing a loss at lease commencement (hereinafter referred to as a day-one loss) even if the lessor expects that the arrangement will be profitable overall.

BC8. Certain preparers and practitioners continue to emphasize that recognizing an immediate loss for a sales-type lease with variable payments that do not depend on a reference index or a rate results in reporting outcomes that do not faithfully represent the underlying economics either at lease commencement or over the lease term. Those stakeholders emphasize that users of financial statements are not provided with financial information that is relevant or decision useful. Because lease arrangements with variable payment structures based on the performance or use of underlying assets are becoming more prevalent, particularly in the energy industry, stakeholders from that industry requested that the Board amend the leases guidance to address this issue.

BC9. Those stakeholders further emphasized that lessors did not recognize an immediate loss under Topic 840 because of the longstanding practice to account for leases with substantial variable payments as operating leases on the basis of an interpretation of a classification criterion in Topic 840. That classification criterion was not retained in Topic 842.

BC10. At its July 29, 2020 meeting, the Board discussed the day-one loss issue and agreed that recognizing a loss at lease commencement for lease contracts that a lessor expects to be profitable overall results in reporting outcomes that do not reflect the economics of the transaction. Therefore, the Board decided to amend the lease classification requirements to require that a lessor classify and account for a lease with lease payments that are predominantly variable and do not depend on a reference index or a rate as an operating lease. The Board decided that the amendments in this proposed Update are a practical solution resulting in financial reporting outcomes that more faithfully represent the economics of the transaction. Additionally, the Board noted that accounting for leases with payments that are predominantly variable and do not depend on a reference index or a rate as operating leases more closely aligns with the financial reporting for those leases under IFRS 16. The Board considered whether a lessor should be required to estimate all variable lease payments (similar to the requirements in Topic 606, Revenue from Contracts with Customers) to address the day-one loss issue. The Board decided that while that would be a conceptually better solution, it would be inconsistent with the treatment of variable lease payments by lessees and would introduce additional costs and complexity for the lessor that were previously considered in the Board's deliberations leading up to the issuance of Update 2016-02. The Board noted that no new information exists indicating that those costs and that complexity would be reduced in the current environment and, thus, rejected a solution that would have required that all lessors estimate variable payments.

BC11. In determining the threshold for the magnitude of variable lease payments that do not depend on a reference index or a rate needed for a lease to be classified as operating by lessors (for example, "substantially all," "significant," "majority," "predominant," and so forth), the Board sought to strike a balance. Having a threshold that is too low could promote structuring to achieve operating lease accounting and would require that many lessors estimate the magnitude of variable payments that do not depend on a reference index or a rate. A threshold that is too high may not capture most leases with the day-one loss issue.

BC12. On the basis of feedback received, the Board decided that "predominant" was the appropriate threshold because it would capture most leases with the day-one loss issue (acknowledging that leases with predominantly variable payments could nonetheless still produce a selling profit). The Board noted that "predominant" is successfully applied in other areas of lessor accounting, such as when determining whether a combined component (lease and nonlease) should be accounted for within Topic 606 (see paragraph 842-10-15-42B) and, accordingly, could be consistently applied in practice. Finally, the Board observed

that the evaluation of lease payments is a binary evaluation. That is, payments for the lease can only be either fixed or variable. Therefore, for purposes of applying the amendments in this proposed Update for this issue, “predominant” is considered equivalent in meaning to “majority.”

BC13. The Board decided that a lessor often should be able to qualitatively determine whether variable payments that do not depend on a reference index or a rate are predominant in a lease. The Board noted that there may be situations in which it is unclear whether those variable payments are predominant when compared with fixed payments in a lease that has both fixed and variable lease payments, and, therefore, a lessor may have to estimate the variable payments to determine whether those payments are predominant in that lease. The Board believes that a lessor could make that determination because the lessor would have developed quantitative estimations to evaluate the expected profitability of the lease arrangement.

BC14. The Board acknowledged that the amendments in this proposed Update to address the day-one loss issue will result in a lessor classifying more leases as operating leases (as opposed to sales-type leases). Consequently, leases that otherwise would not qualify for the practical expedient in paragraph 842-10-15-42A to combine lease and nonlease components and account for them as a single component may now qualify for that expedient. This is because the scope of the expedient is limited to operating leases. The Board decided that this would result only in situations in which the pattern of transfer of the nonlease component is over time (consistent with the pattern of transfer of benefits from a lessor to a lessee in an operating lease) and not at a point in time (for example, when the nonlease component is a consumable product), consistent with what is currently required by paragraph 842-10-15-42A.

BC15. Additionally, the Board acknowledged that more leases being classified as operating by lessors may result in more sale and leaseback transactions accounted for by buyer-lessors (not seller-lessees) as successful purchases of the asset. This is because the guidance on sale and leaseback transactions in Subtopic 842-40 considers classification to determine whether the transaction is accounted for as a successful sale. A buyer-lessor is not considered to have obtained control of the underlying asset if the leaseback is classified as sales-type but is considered to have obtained control if the leaseback is classified as operating. For a buyer-lessor, the difference in accounting for the sale and leaseback transaction as a successful purchase of the asset is primarily balance sheet classification. Furthermore, the Board emphasized that the successful sale accounting by a lessor would have no effect on lessee accounting because the amendments proposed in paragraph 842-10-25-3A would not affect the principles related to transfer of control in Topic 842 (or lease classification criteria in paragraph 842-10-25-2) but, rather, would be a practical solution only for lessors with a day-one loss issue. Specifically, regardless of a lessor’s accounting, if a lessee classifies a lease as a finance lease, that lessee cannot account for the transfer of the underlying asset in a sale and leaseback transaction as a successful

sale. Rather, it would account for the transaction as a failed sale and leaseback transaction by not derecognizing the underlying asset and recognizing a financial liability for any amounts received.

Issue 2: Option to Remeasure Lease Liability—Lessee Only

BC16. Topic 842 prohibits a lessee from remeasuring its lease liability solely for a change in a reference index or a rate upon which some or all of the variable lease payments are based. Rather, any change in future payments resulting from changes in a reference index or a rate is accounted for as a variable lease cost. That variable lease cost is recognized in the period in which the obligation for those payments is incurred. Certain stakeholders expressed that because IFRS 16 requires a lessee to remeasure the lease liability in subsequent periods when a change to the lease payments resulting from a change in a reference index or a rate takes effect, precluding lessees from similar remeasurement of lease liabilities under Topic 842 has resulted in increased costs for dual reporting entities. In developing Topic 842, the Board recognized that remeasuring the lease liability provides the most updated information about a lessee's future cash obligations. Notwithstanding, the Board decided to prohibit that remeasurement based on feedback that the benefits of remeasuring a lease liability solely for changes in a reference index or a rate would not justify the costs associated with requiring that remeasurement.

BC17. Many preparers that issue financial statements in accordance with both GAAP and IFRS Standards noted that the differences in the requirements in Topic 842 and IFRS 16 create ongoing costs and complexity primarily because those preparers are required to maintain separate lease payment analyses and schedules for GAAP and IFRS Standards reporting purposes. Those stakeholders also noted that the Board had recognized that remeasurement provides the most updated information and, therefore, requested that the Board amend the existing requirements in Topic 842 to permit (but not require) a lessee to remeasure lease liabilities for changes in a reference index or a rate affecting future lease payments at the date that those changes take effect, consistent with the requirement in IFRS 16.

BC18. The Board agreed with those stakeholders and decided at its July 29, 2020 meeting to provide lessees with an option to remeasure lease liabilities (with an offset to the corresponding right-of-use asset in most cases) solely for changes in a reference index or a rate affecting future lease payments at the date that those changes take effect. That option would be required to be applied at the entity-wide level. The Board decided that by making this amendment optional (rather than a requirement), each entity would be able to select the method that is most cost-effective for its circumstances.

BC19. To provide transparency about whether an entity has elected the option to remeasure lease liabilities solely for changes in a reference index or a rate affecting future lease payments, the Board decided that an entity that elects the option would be required to disclose that fact. The Board also acknowledged that providing an option (as opposed to a requirement to remeasure a lease liability) may create comparability issues, which could increase costs for users of financial statements. Therefore, certain Board members directed the staff to obtain feedback from users of financial statements to determine whether significant concerns exist about the potential lack of comparability caused by the option in the amendments in this proposed Update. Other Board members emphasized that the Board provided other lessee options in Topic 842 for operability and cost reduction purposes that already have created some comparability issues, particularly the option to combine nonlease components with lease components and account for the combined component solely as a lease component (see paragraph 842-10-15-37).

Issue 3: Modifications Reducing the Scope of a Lease Contract

BC20. If a lease contract providing a lessee with the right to use multiple assets (for example, a master lease agreement) is modified such that certain of those rights are terminated early, Topic 842 requires that an entity (both a lessee and a lessor) reconsider the classification and adjust the accounting for the remaining lease components in that contract. This modification accounting is required regardless of whether those remaining lease components are economically affected by the early termination. In practice, an early termination could be effective either at or after the effective date of the modification (for example, because there is a notice period before a lessee can return the leased assets to the lessor).

BC21. Stakeholders questioned the appropriateness of requiring modification accounting for the remaining lease components if the termination of one or more separate lease components does not economically affect the remaining lease components in that lease contract. Multiple preparers raised concerns that reassessing classification and adjusting the accounting for lease components that are economically unaffected by the termination of other lease components are burdensome and cause unjustified cost and complexity. Specifically, this accounting requires that an entity reconsider inputs for classification and measurement purposes, such as the economic life and fair value of the underlying asset and the discount rate. Additionally, stakeholders emphasized that reassessing the classification of economically unaffected remaining lease components during the lease term could change lease classification (for example, a lessor reclassifying a sales-type or direct financing lease to an operating lease) solely because of the passage of time. Those stakeholders asserted that those changes in classification could result in financial reporting that does not represent the economics of the arrangement.

BC22. Consequently, stakeholders requested that the Board amend the guidance on leases to exempt an entity from applying modification accounting to the remaining lease components within a lease contract when other lease components within the contract are terminated and those early terminations do not affect the economics of the remaining components.

BC23. At its July 29, 2020 meeting, the Board decided to amend Topic 842 to exempt an entity from applying modification accounting to the remaining lease components in a lease contract if the economics of the remaining lease components are unaffected by the early termination of one or more separate lease components in that lease contract, regardless of whether the early termination is executed at or after the effective date of the modification. Specifically, the Board decided that when the underlying economics of a remaining lease component within a lease contract are unaffected by the early termination of another lease component in that contract, modification accounting for the remaining lease component is inappropriate. That is, the accounting for the remaining lease component should be unchanged by the early termination of the other lease component in those situations because it better reflects the economics of the remaining terms of the contract. The Board also noted that guidance is provided for situations in which a modification increases the scope of a lease contract without affecting the existing contract (see paragraph 842-10-25-8) but not for modifications that decrease the scope of a lease contract and do not affect the economics of the remaining lease components in that contract.

BC24. The Board noted that an early termination of a lease component in a contract that is executed at the effective date of the modification (referred to as the modification date) would result in the terminated component being derecognized at that date. Additionally, the Board noted that an early termination that is executed after the modification date would result in a reduction of the lease term (rather than an immediate derecognition) for that component at the modification date. In that situation, the Board decided that an entity should apply the existing modification accounting requirements at the modification date to the lease component in the contract that is modified for an early termination. For example, consider a contract with 100 lease components that is modified to early terminate 10 lease components with a termination date that is 6 months after the modification date and the remaining 90 lease components are unaffected in accordance with paragraph 842-10-25-8B. In that example, an entity (a) would not adjust the accounting for the remaining 90 lease components in accordance with paragraph 842-10-25-8B and (b) would apply modification accounting in accordance with paragraph 842-10-25-8C(b) to the 10 lease components that are early terminated. Paragraph 842-10-25-8C(b) leverages the existing modification guidance in Topic 842 (see paragraphs 842-10-15-36, 842-10-15-41, 842-10-25-9, 842-10-25-11 through 25-12, and 842-10-25-15 through 25-18) that may be applicable at a contract level and clarifies how to apply that guidance at a component level.

BC25. In reaching its decision, the Board emphasized that the amendments in this proposed Update would apply to any lease contract (regardless of legal form) that provides a lessee with the right to lease multiple underlying assets that are separate lease components. Specifically, the proposed amendments would not be limited to contracts widely considered master lease agreements. Rather, the proposed amendments would be applied to terminations of one or more, but not all, lease components within any contract with multiple lease components.

BC26. The Board emphasized that changes to the total payments required by the lease contract for the remaining lease components are a critical element to consider when determining whether those components are economically affected by a partial termination of the lease contract. Specifically, the Board noted that a lessee often pays a penalty or fee for a partial termination. Because of this, the Board emphasized that unless the total of (a) the total payments required by the contract over the entire lease term (not just for the remaining lease term) for the remaining lease components and (b) any termination penalties or fees is "substantially the same" as those payments in (a), the economics of the remaining lease components are affected. Therefore, modification accounting in accordance with paragraphs 842-10-25-9 through 25-18 would continue to be appropriate in those situations.

BC27. The Board considered whether payments made in lieu of returning the asset subject to the terminated lease component should be considered the same as a termination penalty or fee when determining whether the total payments are substantially the same. For example, a lessee may purchase an underlying asset or may have experienced a casualty loss, resulting in a partial termination of a lease contract. The Board decided that those payments should be excluded from that comparison, as long as those payments are in accordance with the terms and conditions of the contract or are equal to the fair value of the asset underlying the terminated lease component at the termination date.

BC28. The Board noted that some terminations change the underlying economics of the remaining lease components on a constructive basis, even if the modification terms do not explicitly change the stated terms of the remaining lease components. For example, the existence of a substantive termination penalty in a master lease agreement may economically affect the lease term and lease payments for the remaining lease components even if another lease component within that arrangement is terminated at its commensurate price (see paragraph 842-10-55-23). Additionally, a change in the consideration required for a nonlease component may change the total payments for the remaining lease components because an entity that elected to separate the nonlease component from the lease component must allocate that change in consideration on the same basis as the original consideration in the contract was allocated. Therefore, the Board stressed that it is important to consider all changes associated with a termination of a lease component when determining whether a termination of one or more, but not all, lease components within a lease contract meets the conditions in paragraphs 842-10-25-8A through 25-8B.

BC29. The Board acknowledged that in certain cases entities may not have separated lease components at lease commencement because a separation would have had no effect on the accounting for the lease contract before a modification occurred. For example, in a coterminous lease of five floors in a building or a lease of a stated amount of square footage of retail space in a mall, a subsequent reduction in the number of leased floors or in the amount of square footage of retail space may indicate that the terminated floor or retail space was a separate lease component in the lease contract (even if an entity did not identify and separate those lease components at the commencement date). The Board decided that not separating lease components at the commencement date should not preclude an entity from subsequently applying the amendments in this proposed Update if it is apparent at the termination date that more than one separate lease components existed at lease commencement and the remaining lease components are economically unaffected by the termination.

BC30. Additionally, the Board noted that sometimes a lease component in a contract is terminated early by exercising a contractual option to extend or terminate that lease component that an entity (a lessee or a lessor) previously determined the lessee was not reasonably certain to exercise. The Board noted that the existing guidance for that situation requires that a lessor account for the subsequent exercise of that option in the same manner as a lease modification (see paragraph 842-10-35-3). Specifically, the lessor would apply the lease modification guidance in paragraphs 842-10-25-8A through 25-18. Separately, the Board noted that a lessee would apply the reassessment guidance in paragraphs 842-10-35-1 through 35-2 rather than the lease modification guidance in that situation.

Effective Date and Transition

BC31. The amendments in this proposed Update would amend Topic 842, which has different effective dates for public business entities and entities other than public business entities. The Board will determine the effective date of the proposed amendments after considering feedback from stakeholders.

BC32. The Board decided that for all of the amendments in this proposed Update, entities that have not adopted Topic 842 on or before the effective date of a final Update would follow Update 2016-02's transition requirements. That transition is either (a) retrospective to each prior period presented in the financial statements with the cumulative effect of transition recognized at the beginning of the earliest period presented or (b) retrospective at the beginning of the period of adoption with a cumulative effect of transition recognized at the beginning of the period of adoption.

BC33. The Board decided that for entities that have adopted Topic 842 before the effective date of a final Update, the transition would be as follows:

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

BC34. Early application would be allowed. An entity would be permitted to independently adopt and have a separate transition method for each issue within this proposed Update. For Issue 1, the Board decided that applying retrospective transition to leases that commence or are modified on or after the adoption of the original Update on leases (as opposed to leases existing as of the beginning of the earliest comparative period presented) would be appropriate and provide decision-useful information. This is because stakeholders emphasized that the day-one loss issue is related to a classification criterion in Topic 840 that was not retained in Topic 842. Therefore, the day-one loss issue would mostly be present in accounting for lease arrangements after the adoption of Topic 842 and not under Topic 840. For Issues 2 and 3, the Board did not require full retrospective application. Rather, the Board limited the retrospective application to an entity's adoption date of Topic 842 to avoid requiring that an entity reconsider the effect of Topic 842 transition requirements on the adoption of the amendments related to those Issues.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require improvements to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). We welcome comments on these proposed improvements to the Taxonomy at xbrled@fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, the proposed improvements to the Taxonomy will be finalized as part of the annual release process.