BDO KNOWS: FASB

Definition of a Lease: What's In and What's Out of ASC 842

INTRODUCTION

In February 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued its highly-anticipated leasing standard in ASU 2016-02[1] ("ASC 842" or "the new standard") for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use ("ROU") assets and related lease liabilities on the balance sheet for all leases.[2] The pattern of expense recognition in the income statement will depend on a lease's classification.

For calendar-year public business entities the new standard takes effect in 2019, and interim periods within that year; for all other calendar-year entities it takes effect in 2020, and interim periods in 2021. The full standard is available **here**. BDO's newsletter providing an overview of the new standard is available **here** .

One of the most challenging aspects of the new standard can be identifying when a contract is or contains a lease, in particular determining when service contracts contain embedded leases. This practice aid will briefly discuss the definition of a lease in ASC 842 and provide illustrative examples to demonstrate the concepts.

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1 *Leases (Topic 842)*

2 ASC 842 provides a recognition exemption for leases with terms of one year or less and that do not include a purchase option reasonably certain of exercise. The exemption must be elected by asset class. If this exemption is elected, the lessee does not recognize the related ROU assets and lease liabilities on the balance sheet for short-term leases within that asset class.

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SCOPE

The scope of the new standard is generally consistent with prior guidance as it limits the application of the guidance on identifying leases to leases of property, plant or equipment.

BDO Observation: Although the Board acknowledged in paragraph 110 in the Basis for Conclusions of ASU 2016-02 that the conceptual basis for excluding leases of intangible assets, inventory and assets under construction from the scope of the new standard is unclear, it nonetheless decided to continue to limit the scope of the new standard to property, plant or equipment only. As a result, those other arrangements will continue to be accounted for under ASC 350, ASC 330 and ASC 360, respectively. In addition, leases to explore for or use minerals, oil, natural gas and other similar resources, including leases of mineral rights, will continue to be accounted for under ASC 930 and 932, while leases of biological assets, including timber, will continue to be accounted for under ASC 905.

Land Easements

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in a variety of industries, but are especially common in the energy, utilities, transportation and telecom industries. For example, an electric utility will typically obtain a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by third parties. A land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term.

Diversity in practice currently exists in the accounting for land easements. Entities typically account for their land easements by applying ASC 350, ASC 360, or ASC 840.

Because of that diversity, in January 2018 the FASB issued ASU 2018-01[3] which is intended to reduce the cost and complexity associated with assessing whether all existing and expired land easements meet the definition of a lease under ASC 842. Specifically, ASU 2018-01 allows entities that previously did not account for land easements as leases under ASC 840 to elect a transition practical expedient to not assess those land easements under ASC 842 when adopting the new standard. Instead entities will continue to account for those land easements under other ASCs unless the land easement is modified on or after ASC 842's adoption date. Once an entity adopts ASC 842, it must apply the new standard prospectively to all new or modified land easements that meet the definition of a lease in ASC 842. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient for those easements.

Example 1: Electric Company obtained a series of easements from Southern Railroad years before its adoption of ASC 842. The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company made an upfront payment under the easement agreement in return for perpetual access rights. Electric Company has historically accounted for those land easements along with its poles as property, plant and equipment under ASC 360.

Because Electric Company did not account for those land easements as leases under ASC 840, it may elect the practical expedient provided in ASU 2018-01. This means Electric Company would continue to account for those land easements under ASC 360 unless the agreement is modified on or after ASC 842's adoption date, in which case Electric Company would need to assess whether those easements meet the definition of a lease under ASC 842. If elected, the practical expedient must be applied to all land easements not accounted for as leases under ASC 840.

Alternatively, if Electric Company does not elect the land easements practical expedient, it must evaluate all existing land easements when adopting the new standard to determine whether those easements meet the definition of a lease under ASC 842. In this example, the agreement does not contain a lease. Paragraph 842-10-15-3 states that a lease conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. The fact that the contract is perpetual means that it is not for a specific period of time, and, therefore, the right does not meet the definition of a lease. Careful consideration should be given when evaluating land easements under ASC 842 as terms and conditions may vary greatly between agreements.

3 *Leases (Topic 842): Land Easement Practical Expedient for Transition to ASC 842*

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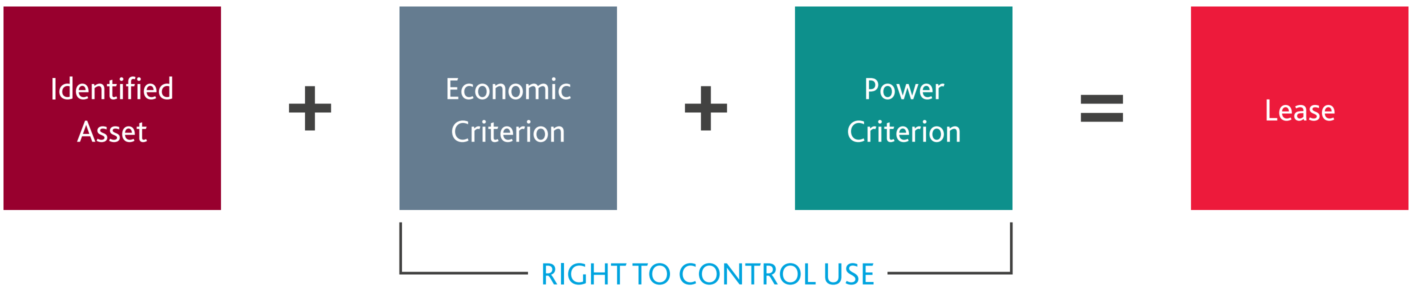
DEFINITION OF A LEASE

The Master Glossary defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

For a contract to be or include a lease, there must be an identified asset and the contract must grant to the customer throughout the period of use both:

(a) The right to obtain substantially all of the economic benefits from the asset's use (the economic criterion), and

(b) The right to direct the use of the identified asset (the power criterion).



Identified Asset

To have an identified asset, a contract must either explicitly or implicitly specify the asset. Similar to prior requirements, an asset is not considered specified if the supplier has the right to substitute similar assets and therefore maintains control over the asset during the period of use. However, under the new standard substitution rights are considered substantive as described in paragraph 842-10-15-10 only if the supplier:

a) Has the practical ability to substitute alternative assets throughout the period of use, and

b) Would benefit economically from the substitution.

Importantly, the evaluation of whether a supplier substitution right is substantive must be based on facts and circumstances at contract inception and must exclude consideration of future events that are not likely to occur (for example, an agreement with a future customer to pay an above-market price for use of the asset).

If a supplier's substitution right is substantive, then there is no identified asset, and thus the contract does not contain a lease. A supplier's right to substitute the asset only on or after a particular date or event, for repairs and maintenance or based on the availability of a technical upgrade, are not considered substantive.

In addition, the new standard highlights that if the asset is located at the customer's premises, the costs associated with substituting the asset are generally higher than when located at the supplier's premises, and therefore are more likely to exceed the related benefits. If the supplier costs to substitute exceed the related benefits, the substitution right would not be substantive. If the customer cannot determine whether a substitution right is substantive, the customer must presume that the substitution right is not substantive (that is, there is an identified asset, and the entity must evaluate the economic and power criteria to determine whether there is a lease).

BDO Observation: As noted above, the requirement that a right of substitution would provide economic benefits to the supplier in order to be considered substantive is new and may require significant judgment. Due to this guidance, more contracts may be deemed to include a lease than under prior guidance because they include an identified asset. This determination becomes more important under the new standard due to the balance sheet implications for the lessee.

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Right to Control Use (Economic and Power Criteria)

In addition to relating to an identified asset, the customer must also have the right to control the use of that asset which requires the economic criterion and the power criterion to be met.

BDO Observation: Although the right to control the use of an identified asset is not a new concept, the application in ASC 842 is different than in ASC 840. Specifically, under the guidance in ASC 840, a contract was deemed to contain a lease if:

(a) The customer controlled the operation of the asset while obtaining more than a minor portion of the output of the asset,

(b) The customer controlled physical access to the asset while obtaining more than a minor portion of the output of the asset, or

(c) It was remote that any other party would receive more than a minor portion of the output of the asset and the price for the output was neither fixed per unit nor equal to the market price at time of delivery.

Under ASC 842, the lessee must have both the right to obtain substantially all of the economic benefits and the right to direct the use of the asset, which was not a prerequisite under ASC 840. As a result, certain contracts that met the definition of a lease under ASC 840 (for example power purchase agreements under (c) above) may no longer meet the definition of a lease under ASC 842.

ECONOMIC CRITERION

A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third-party.

The economic criterion requires that a customer has the right to obtain substantially all of the economic benefits from the use of that asset.

BDO Observation: In practice, the term "substantially all" is generally interpreted as being at or around 90% or more. This term is also used in the lease classification test (see paragraphs 842-10-25-2 and 25-3), as well as in many other areas of U.S. GAAP. An entity should ensure consistent application of the threshold. And in many cases, it will be straightforward to conclude that the customer obtains substantially all of the economic benefits (for example, when the customer has exclusive use of the asset).

POWER CRITERION

The power criterion is met if:

a) The customer can direct how and for what purpose the asset is used throughout the period of use (i.e., the customer directs the relevant decisions during the period of use), or

b) When the relevant decisions are predetermined,

    1. The customer designed the asset in a way that predetermined the relevant decisions, or

    2. The customer has the right to operate (or direct others in operating) the asset throughout the period of use.

The relevant decision-making rights to consider include, for example, the right to change the type of output produced by the asset, the right to change when or where the output is produced, the right to change whether the output is produced and how much output is produced, if any. These rights are examples only and are neither determinative nor prescriptive. For example, a requirement to use an asset in a specified location does not necessarily imply that the lessee does not direct the use of the asset.

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RESTRICTIONS AND SUPPLIER PROTECTIVE RIGHTS

Both the economic and control criteria are evaluated within the defined scope of the customer's right to use the asset. Terms that limit the use of the asset a certain way (for example specifying a maximum amount of usage of the asset) or that protect the supplier's interest in the asset (such as requiring the customer to follow industry-standard operating procedures, or requiring notification of changes in how or where the asset will be used) do not, in isolation, prevent the customer from having the right to direct the use of the identified asset. For example, if a customer enters into a contract for the use of a corporate jet for a two-year period, restrictions within the contract limiting the number of hours the jet can be flown and/or which territories the aircraft can fly over will not prevent the customer from directing the use of the aircraft if, within that defined scope of the contract, the customer for example has exclusive use of the corporate jet throughout the two years (i.e., the economic criterion is met) and the customer decides where and when the aircraft will travel and what passengers and cargo it will transport throughout the two years (i.e., the power criterion is met).

The three key concepts (identified asset, economic criterion and power criterion) are explored through various examples below. Note that some of the examples may include nonlease components (for example, maintenance services). The examples provided herein, and conclusions reached, focus solely on whether there is a lease.

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EXAMPLES

Example 2

CONCEPTS EXPLORED

- Identified Asset
- Economic Criterion
- Power Criterion

EMPHASIS

- Substitution rights
- Scope of use

BACKGROUND

Paper Co enters into a contract with Printers R Us for the exclusive use of a copy machine for three years. Under the contract, the copier is explicitly specified by serial number, but Printers R Us has the right to replace the copier at any time during the agreement, including in lieu of repairing it, without Paper Co's approval.

While the contract specifies a location for the copier, Paper Co has the right to move the copier to any of its facilities upon three days written notice to Printers R Us. Paper Co also has the right to decide when to use the copier and when it uses it, how many copies it makes (subject to a limit of 5,000 copies per month).

ANALYSIS

Is there an identified asset? Yes

Although Printers R Us has the right to replace the copy machine at any time and without Paper Co's approval, such substitution would likely not generate an economic benefit for Printers R Us. As noted in paragraph 842-10-15-12, if the asset is located at the customer's premises, then the costs associated with substitution are likely to exceed the benefits associated with substituting the asset. Specifically, in this example Printers R Us would incur costs to substitute the copy machine, such as employee time and costs of transporting and installing another copy machine and removing and transporting back the original copy machine. It is not likely that events or circumstances would arise at contract inception from which Printers R Us would generate more cash flows by substituting the copy machine than the costs it would incur. In addition, as noted in paragraph 842-10-15-14, rights to substitute identified equipment solely for repairs and maintenance are not substantive. Accordingly, Printers R Us' substitution right is not substantive and there is an identified asset.

Is the economic criterion met? Yes

Paper Co has the right to obtain substantially all of the economic benefits from the use of the copier because it has exclusive use of the copier.

Is the power criterion met? Yes

The 5,000-copy limit per month protects Printer R Us' copier and in effect defines the scope of the contract. Within that scope, Paper Co has the right to direct the use of the copier, including when to use it and for how long, how many copies to make (subject to the limit) and where to use it, throughout the three-year period. Those decisions are the relevant decisions that impact the economic benefits from use of the copier.

Therefore, the contract is a lease.

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Example 3

CONCEPTS EXPLORED	EMPHASIS	BACKGROUND
Identified Asset	▶ Substitution rights	Outpatient Services, Inc. ("OSI") signs a contract with Medical Equipment Company ("MEC") under which OSI will use five chemotherapy machines for a period of three years. The machines are delivered to OSI's location, and OSI has the right to use the machines in any way and at any time it deems appropriate during the three-year term of the agreement, subject to restrictions requiring the machines to be used pursuant to manufacturer-provided and FDA approved use guidelines. Each machine is expected to be able to provide up to 1,000 treatments before needing maintenance, and each machine has an expected useful life of approximately 5,000 treatments, which normally equates to five to six years. However, each machine can only be used to provide up to ten chemotherapy treatments before being recalibrated pursuant to FDA guidelines, at which time MEC is required to provide the services necessary to allow OSI to continue providing its chemotherapy services. MEC maintains a large pool of chemotherapy machines at specified locations (which are within a reasonable distance from its customers) which have been properly cleaned and calibrated. When OSI contacts MEC to request recalibration of one of its machines, MEC retrieves that machine and replaces it with a fresh machine. MEC also has the right to replace a machine at its convenience.

ANALYSIS

Is there an identified asset? No

While the machines are housed at OSI's location, MEC has the right to substitute throughout the three years another equivalent machine rather than calibrating the machine originally delivered and that right is considered substantive because:

- MEC has the practical ability to substitute each machine throughout the period of use considering its large pool of machines and reasonable distance from its customers. MEC also does not need OCI's approval to substitute the machines,
- MEC would benefit economically because MEC has centralized calibration operations in a small number of facilities within a reasonable distance from its customers which allows it to reduce costs of calibration (including transportation) in excess of the costs that it otherwise would incur to calibrate the machines at the clients' location, while ensuring constant access to calibrated machines for its customers as required per the agreement. Those events are likely to occur at contract inception considering MEC's historical experience, business and operations. In addition, MEC may benefit from replacing a machine prior to a customer's request if MEC is replacing another machine in that customer's general vicinity, as that further reduces MEC's transportation costs.

The contract does not contain a lease.

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Example 4A (Adapted from paragraphs 842-10-55-42 through 55-47)

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Substitution rights
- Scope of use

BACKGROUND

Smith & Company ("SmithCo") enters into an agreement with Freight Systems Limited ("Freight") under which Freight provides SmithCo with the use of ten rail cars of a particular type for five years. The contract specifies the rail cars, which are owned by Freight. The agreement provides certain limitations on what types of goods SmithCo can transport, such as hazardous materials or explosives, but otherwise, SmithCo has the right to determine whether the rail cars are used, and if so, where, when and which products are transported using the rail cars. When the rail cars are not in use, they are stored at SmithCo's property. If a particular car needs to be serviced or repaired, Freight is required to substitute a rail car of the same type. Otherwise, Freight cannot retrieve the rail cars during the five-year period of the contract other than on default by SmithCo.

ANALYSIS

Is there an identified asset? Yes

The agreement includes ten identified rail cars. Once the cars are delivered to SmithCo, they can only be substituted when they need to be serviced or repaired, which is not considered a substantive substitution right based on the guidance in paragraph 842-10-15-14.

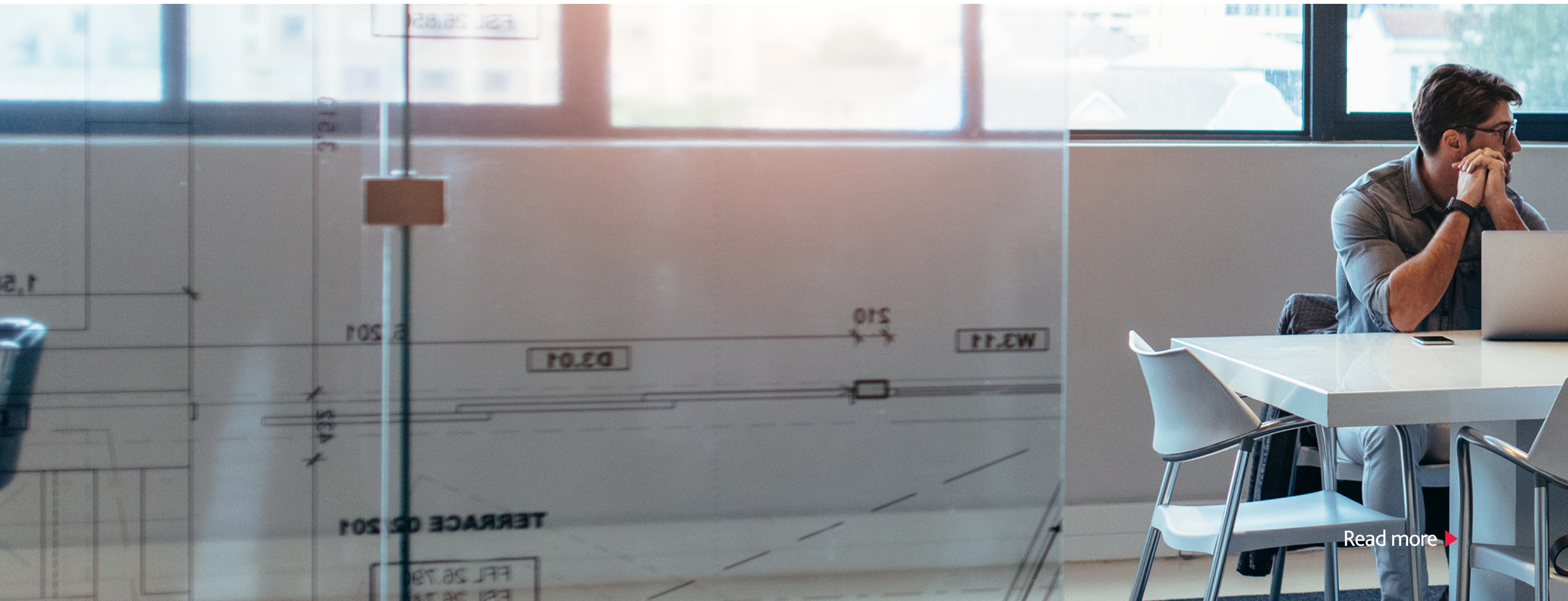
Is the economic criterion met? Yes

SmithCo has the right to obtain substantially all of the economic benefits related to the use of the rail cars over the five-year period of use because SmithCo has exclusive use of the cars during that period.

Is the power criterion met? Yes

SmithCo has the right to direct the use of the cars. The contractual restrictions on the cargo that can be transported are protective rights of Freight and those define the scope of SmithCo's right to use the rail cars. Within that scope, SmithCo has the right to determine whether the rail cars are used, and if so, where, when and which products are transported using the rail cars.

The contract contains a lease of ten rail cars.



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Example 4B (Adapted from paragraph 842-10-55-48 through 55-51)

CONCEPTS EXPLORED	EMPHASIS	BACKGROUND
Identified Asset	▶ Substitution rights	Assume the same facts as Example 4A except that the contract between SmithCo and Freight requires Freight to transport a specified quantity of products by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of products specified are economically equivalent to SmithCo having the use of ten rail cars for five years. Freight has a large pool of similar rail cars that can be used to fulfill the requirements of the contract. The rail cars are stored at Freight's location when not in use.

ANALYSIS

Is there an identified asset? No

The rail cars used to transport SmithCo's products are not identified assets. Freight has the practical ability to substitute each rail car throughout the period of use without SmithCo's approval, and Freight would benefit economically from substituting each car because the costs to substitute are minimal, and substitution allows Freight to use the cars that in the most efficient way for the task, for example because they are currently at a rail yard close to the point of origin. Those conditions are likely to occur at contract inception considering Freight's historical experience, business and operations. Accordingly, Freight's substitution right is substantive. Therefore, although SmithCo has the right to use the equivalent of ten rail cars for five years, Freight directs the use of those rail cars by determining which cars will be used for each particular delivery.

The agreement does not contain a lease.

Example 5 (Adapted from paragraph 842-10-55-63 through 55-71)

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Substitution rights
- Economic benefits
- Scope of use

BACKGROUND

Retailer enters into a contract with Mall Owner for the use of retail unit A for a five-year period. Retail unit A is part of a larger mall space with many retail units. Retailer is required to use retail unit A to operate its well-known store brand to sell its goods during the hours that the mall is open. Retailer makes all of the decisions about the use of retail unit A during the period of use (e.g., deciding on the mix of goods and at what price to sell them), and controls physical access to the unit throughout the term. Retailer will pay Mall Owner $50,000 per month plus 6% of monthly net sales.

Mall Owner can require Retailer to relocate to another retail unit. In that case, Mall Owner is required to provide Retailer with a retail unit of similar quality and specifications as retail unit A and to pay for Retailer's relocation costs, including reimbursement for any leasehold improvements that cannot be relocated.

ANALYSIS

Is there an identified asset? Yes

Retail unit A is an identified asset which is explicitly specified in the contract. Mall Owner's substitution right is not substantive. Mall Owner would benefit economically from relocating Retailer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Retailer and other tenants in the space that the new tenant will occupy. Although it is possible that those circumstances will arise, at contract inception it is not likely that those circumstances will arise, and whether such circumstances occur is highly susceptible to factors outside of Mall Owner's influence.

Is the economic criterion met? Yes

Retailer has exclusive use of unit A and therefore obtains substantially all of the economic benefits from use. Although Retailer will pay Mall Owner a portion of the cash flows derived from sales in retail unit A (i.e., 6% of monthly net sales), this represents consideration that Retailer pays to Mall Owner for the use of retail unit A and it does not affect the evaluation of the economic criterion in accordance with paragraph 842-10-15-19.

Is the power criterion met? Yes

The contractual restrictions on the types of goods that can be sold and when the store must be open define the scope of Retailer's use of retail unit A, but within that scope, Retailer makes the relevant decisions about how and for what purpose the space is being used (for example, how much inventory to hold at the store, the mix of its goods to sell, the price of goods sold, etc.).

The contract contains a lease of retail space.

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Example 6

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Scope of use

BACKGROUND

Pizzeria Co. enters into a syrup supply agreement with Beverage Co. under which Beverage Co. agrees to supply soft drink syrup to Pizzeria Co. for three years. In addition, Beverage Co. will provide dispensers that combine the syrup with CO_2 to deliver soft drinks to Pizzeria Co.'s customers. Pizzeria Co. is responsible for purchasing the CO_2 and for maintaining the dispensers, and the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's syrup. Beverage Co. will provide two maintenance services per year per store to repair the dispensers at no charge, but additional maintenance visits will be charged on a time and materials basis. Otherwise, the pricing under this agreement is completely variable. That is, it is based on the volume of syrup purchased by Pizzeria Co.

ANALYSIS

Is there an identified asset? Yes

While the agreement does not explicitly specify the individual beverage dispensers, the units are implicitly specified because the dispensers are required for Beverage Co. to fulfill its promise under the arrangement, and once installed, Beverage Co. has no right to substitute the installed equipment.

Is the economic criterion met? Yes

Pizzeria Co. has exclusive use of the beverage dispensers.

Is the power criterion met? Yes

Pizzeria Co. has the right to direct the use of the dispensers including determining when and how often to use them. The fact that the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's products is a protective right that does not prevent Pizzeria Co. from controlling their use.

The agreement contains a lease.[4]

4 Because the pricing in this agreement is solely variable, Pizzeria Co. would not have a right-of-use asset or lease liability to recognize. However, Pizzeria Co. would need to consider the relevant lessee disclosures required by ASC 842-10-50. In addition, Pizzeria Co. could consider electing the practical expedient in paragraph 842-10-15-37 to not separate the lease and nonlease components for this asset class, and which would enable it to treat the treat the entire contract (and others in the same asset class) as a lease component.

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Example 7

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Capacity portions versus physically distinct assets

BACKGROUND

The owner of a co-location warehouse ("Co-Lo") enters into an agreement with Software Company ("Software") under which Software will install its servers and other IT equipment used to host and run its software platform. The agreement identifies specific space within the larger warehouse for Software to use, and indicates that Co-Lo does not have the right to relocate Software's equipment once it is installed. The space that Software will occupy does not represent substantially all of the capacity of the warehouse. However, Software is required to install cages and other barriers that segregate its equipment from the rest of the warehouse, thus effectively physically segregating the space it is using.

ANALYSIS

Is there an identified asset? Yes

Although the space is not initially a physically distinct portion of the larger warehouse and the space occupied does not represent substantially all of the capacity of the warehouse, the caging and other barriers required to be installed by Software render the space physically distinct and allow Software to control access to that specific space. In addition, Co-Lo has no ability to substitute comparable space throughout the term of the contract. Therefore, there is an identified asset.

Is the economic criterion met? Yes

Because Software has the right to control access to the specified space, it has the right to obtain substantially all of the economic benefits from use of the space (it has exclusive use of it).

Is the power criterion met? Yes

Software has the ability to make decisions about whether to use the space, and if so, when, how and how much to use the space.

The contract is a lease.

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Example 8

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Substitution rights (supplier versus customer)

BACKGROUND

ABC Company ("ABC") enters into a hosting arrangement with Small Hosting Co. ("Small Hosting") under which Small Hosting will provide a specific number of servers and related IT equipment on which it will host software licenses owned by ABC. In addition, Small Hosting will provide connectivity to allow ABC to access the software hosted by Small Hosting.

Because of the number of users in ABC's environment and the complexity of the software environment, Small Hosting must host ABC's software on dedicated servers, i.e. no other customer can be hosted on the same servers. However, Small Hosting has the right to rehome ABC's software onto different servers without ABC's approval so long as access to its software licenses is uninterrupted.

Although Small Hosting will provide monitoring services, ABC makes all decisions about which software to load onto the servers, and what types and how much data to transmit using the servers.

ANALYSIS

Is there an identified asset? Yes (ABC), No (Small Hosting)

Small Hosting considers whether this arrangement contains identified assets (i.e., servers and related IT equipment). Small Hosting considers that it has several facilities and numerous servers from which it can host ABC's software, and that ABC cannot prevent it from switching servers so long as access to its software is uninterrupted. Therefore, Small Hosting concludes that it has the practical ability to substitute ABC's servers and other IT equipment. Small Hosting also considers its right to rehome that software and concludes that it would obtain an economic benefit from substitution. Specifically, it is common for new hosting customers to be obtained, at which time Small Hosting often reconfigures its server space. In addition, to maximize performance on its servers, Small Hosting regularly adds or deletes servers and moves customers as needed. Accordingly, Small Hosting concludes that its right of substitution is substantive, and therefore the contract does not include identified assets and thus is not a lease.

ABC, however, does not have visibility into Hosting's operating practices and business (including how many servers Small Hosting has and how many customers it serves). Therefore, it concludes pursuant to the guidance in paragraph 842-10-15-15 that Small Hosting's right of substitution is not substantive, which means the agreement includes identified assets.

Is the economic criterion met? Yes (ABC Only)

Small Hosting must host ABC's software on dedicated servers, which means no other customer can be hosted on those servers. Accordingly, ABC has exclusive use of the servers and therefore it obtains substantially all of the economic benefits from use of those.

Is the power criterion met? Yes (ABC Only)

ABC makes all decisions about which software to load onto the servers, and what types and how much data to transmit using the servers. Those are the relevant how and for what purpose decisions.

Small Hosting concludes that it does not have a lease.

ABC concludes the agreement contains a lease and a monitoring service. ABC could elect the practical expedient to not separate lease and nonlease components but to account for the combined component as a lease under ASC 842.

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Example 9

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

BACKGROUND

Telco enters into an agreement with Logistics Company which requires Logistics Company to build a warehouse in a specified geographic area. Logistics Company is the legal owner of the warehouse and continues to be throughout the term of the contract. The agreement does not result in Telco controlling the warehouse under construction based on the guidance in paragraph 842-40-55-5. While Logistics Company has some latitude in selecting the location of the warehouse, it must be located in the specified area, and once constructed it cannot be relocated or substituted, even within the specified area, absent extraordinary circumstances (for example, destruction by fire). For the five-year term of the agreement, Logistics Company will process all returned handsets directed by Telco to this warehouse pursuant to repair instructions provided by Telco. If Telco does not direct handsets to the warehouse, then the warehouse does not operate. Logistics Company is not allowed to service any customers other than Telco in the warehouse under the agreement. Logistics Company is required to operate and maintain the warehouse daily in accordance with industry-approved operating procedures.

ANALYSIS

Is there an identified asset? Yes

Once the location is selected and the warehouse constructed, Logistics Company does not have the right to substitute the specified warehouse location.

Is the economic criterion met? Yes

If Telco does not direct handsets to the warehouse, the warehouse does not operate because Logistics Company is not allowed to service other customers. In other words, Telco has exclusive use of the warehouse.

Is the power criterion met? Yes

Telco makes the relevant decisions about how and for what purpose the warehouse is used because it has the right to determine whether, when and how many handsets are processed in the warehouse. Because Logistics Company is precluded from using the warehouse for any other customer or purpose, Telco's decision making about the timing and quantity of handsets processed in effect determines whether and when the warehouse will be utilized.

The contract contains a lease.

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Example 10 (Adapted from paragraph 842-10-55-100 through 55-107)

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

BACKGROUND

Brand X enters into an agreement with Contract Manufacturing Company ("CMC") to purchase a particular type, quality and quantity of shirts for a three-year period. The type, quality and quantity of shirts are specified in the contract.

CMC has only one factory that can meet the needs of Brand X and it is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory significantly exceeds the output for which Brand X has contracted. CMC makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Brand X's contract.

ANALYSIS

Is there an identified asset? Yes

The agreement contains an implicitly specified asset because CMC can only fulfill the contract through the use of this factory.

Is the economic criterion met? No

Brand X does not have the right to obtain substantially all of the economic benefits from use of the factory. CMC could decide to use the factory to fulfill orders from other customers during the three-year term of the agreement, and the capacity of the factory significantly exceeds the output for which Brand X has contracted.

Is the power criterion met? No

Brand X's rights are limited to specifying output from the factory in its contract, and it has only the same rights regarding use of the factory as do any other customers purchasing shirts or other products from the factory. Instead, CMC has the right to direct the use of the factory because it can decide how and for what purpose the factory is used.

The agreement does not contain a lease.

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Example 11

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Economic benefits
- Relevant decisions

BACKGROUND

Midstream Company ("Midstream") owns and operates an oil and gas gathering system in a specific area within the Permian basin. Midstream enters into a gas gathering agreement with Oil & Gas Company ("O&G") to provide gathering services for O&G in the area covered by Midstream's gathering system for a period of 10 years. The pipeline lateral used to fulfill the contract is connected to Midstream's integrated pipeline system.

The contract provides Midstream with the exclusive right to receive, gather and transmit all gas produced by O&G in the area, and the system must always be available to transmit the gas produced by O&G. However, Midstream retains certain rights associated with the pipeline lateral. For example, Midstream can use the pipeline lateral to store other customers products, to use it for system balancing purposes, or to take advantage of market price fluctuations through park and loan services. Midstream also has the right to connect other pipelines to the pipeline lateral without O&G's consent as long as Midstream continues to service the volumes produced by O&G.

ANALYSIS

Is there an identified asset? Yes

The pipeline lateral is explicitly identified, and Midstream does not have an alternative asset that could be used to fulfill the contract. Paragraph 842-10-15-16 also describes "a segment of a pipeline that connects a single customer to the larger pipeline" as one example that is considered an identified asset.

Is the economic criterion met? No

Although Midstream's system must always be available to transmit the gas produced by O&G, O&G does not have exclusive use of the pipeline lateral because Midstream has the right to use the pipeline for other purposes. The pipeline lateral can handle more capacity than the capacity requested by O&G and Midstream also can increase the capacity of the pipeline lateral through various mechanisms. Midstream has the right to use that excess capacity for its own economic benefits throughout the 10 years (for example, to store other customers' products, for system balancing purposes, to take advantage of market price fluctuations through park and loan services, etc.) and those economic benefits are considered significant.

Is the power criterion met? No

O&G can only request that Midstream transports the quantity of gas that it produced and does not have the right to direct how and for what purpose the pipeline is used. Midstream retains the relevant decisions about the use of the pipeline lateral throughout the 10 years. Those decisions include whether to store other customers' products or use excess capacity for other purposes, whether to connect additional pipelines, etc. Midstream makes those decisions throughout the 10-year contract.

The agreement does not contain a lease.

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Example 12A (Adapted from paragraph 842-10-55-108 through 55-111)

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Economic benefits from use of the asset (renewable energy credits vs. tax credits)
- Relevant decisions are predetermined

BACKGROUND

County Electric Company ("CEC") enters into a contract with Solar Power Co. ("Solar") to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, Solar has no substitution rights, and the energy cannot be provided from another asset.

CEC designed the solar farm before it was constructed – CEC hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Solar is responsible for building the solar farm to CEC's specifications and then operating and maintaining it on a daily basis in accordance with industry-approved operating practices.

Solar will receive tax credits related to the construction and ownership of the solar farm, while CEC receives renewable energy credits that accrue from the use of the solar farm.

ANALYSIS

Is there an identified asset? Yes

There is an identified asset because the solar farm is explicitly specified in the contract, and Solar does not have the right to substitute the specified solar farm.

Is the economic criterion met? Yes

CEC takes all the electricity produced by the farm, as well as the renewable energy credits that are a by-product from the use of the farm. Although Solar receives economic benefits from the solar farm in the form of tax credits, those credits relate to the ownership of the solar farm rather than from its use, and thus are not considered in the evaluation of the economic criterion.

Is the power criterion met? Yes

There are no decisions to be made during the period of use about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions.

Although CEC does not operate the solar farm, its design of the farm has given it the right to direct the use of the farm. Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, CEC's control over that design is substantially no different from CEC controlling those decisions.

This contract contains a lease.

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Example 12B (Adapted from paragraph 842-10-55-112 through 55-116)

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Relevant decisions are predetermined

BACKGROUND

Assume the same fact pattern as in Example 12A, except that Solar designed the solar farm when it was constructed prior to entering into the contract with CEC, and CEC had no involvement in that design.

ANALYSIS

Is there an identified asset? Yes

Same as Example 12A.

Is the economic criterion met? Yes

Same as Example 12A.

Is the power criterion met? No

As in Example 12A, the relevant decisions about how and for what purpose the solar plant is used are predetermined. However, in contrast to Example 12A, CEC is not considered to have the relevant decision-making rights about the use of the solar farm because it did not design the solar farm and it does not operate the solar farm. Solar does, and therefore Solar has the right to direct the use of the farm.

The contract does not contain a lease.

Read more

Example 13

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Relevant decisions

BACKGROUND

EZ Co owns and operates a group of convenience stores. EZ Co enters into an agreement with State Bank in which State Bank will provide armored car services to EZ Co for three years. During the term of the contract, State Bank will collect cash and checks from each store location three times per week, and those dates and times are predetermined in the contract and cannot be changed absent emergency situations.

State Bank also provides one smart safe for each store location. The smart safe is connected electronically to State Bank's system and will transmit the value of cash and checks deposited into the safe to State Bank such that EZ Co receives credit in its bank account with State Bank within 24 hours of that deposit. Only State Bank has the right and ability to access the smart safes. Once an EZ Co employee deposits cash or checks into the safe, EZ Co cannot retrieve those items prior to State Bank's armored car service collecting them. However, EZ Co decides when to make deposits, as well as how much cash to deposit versus how much to retain for operating purposes.

ANALYSIS

Is there an identified asset? Yes

Each smart safe is implicitly specified once it is installed at the convenience store location, and State Bank does not have any substitution rights.

Is the economic criterion met? Yes

EZ Co obtains substantially all of the economic benefits from use of the safes throughout the three-year term of the contract because it has exclusive use of those safes. No other customer of State Bank can use the safes.

Is the power criterion met? Yes

Although State Bank has the right to access the safes to collect the funds deposited in them, that access is predetermined in the contract (the dates and times are predetermined in the contract and cannot be changed absent emergency situations). The ability to access the safes also would not grant State Bank the right to determine how and for what purpose the safe is used given the fact that State Bank gives EZ Co access to funds deposited in the safe in EZ Co's bank account prior to the funds actually being collected by State Bank. EZ Co determines whether to use the safe, and if so, when to use it and how much cash and checks to deposit into the safe throughout the period of use.

The agreement contains a lease (each smart safe is a lease).

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Example 14

CONCEPTS EXPLORED

Identified Asset

Economic Criterion

Power Criterion

EMPHASIS

- Relevant decisions

BACKGROUND

Big Oil Inc. ("BOI") enters into an agreement with Drilling Company ("DrillCo") whereby DrillCo will provide BOI with an offshore drilling rig for use in a specified geographical area in the Gulf of Mexico in which BOI has exclusive exploration rights. DrillCo has no other drilling rig in the Gulf of Mexico which could be used to fulfill the contract.

DrillCo will provide the employees and management expertise necessary to operate the drilling rig. However, DrillCo will operate the rig under BOI's instructions (for example, where to drill, how long for and at what depth, and where to drill next). The initial term of the agreement is two years and the agreement automatically renews for additional three-month periods unless either party provides a notice of non-renewal. During the period of the agreement, DrillCo will provide drilling services to BOI using the identified drilling rig. DrillCo has no other drilling rig in the Gulf of Mexico which could be used to fulfill the contract.

ANALYSIS

Is there an identified asset? Yes

The agreement specifies a drilling rig and DrillCo has no other rig which can be used to fulfill the contract.

Is the economic criterion met? Yes

BOI receives substantially all of the output from use of the drilling rig because it has exclusive use of the rig. DrillCo cannot use the rig to provide services to any other customer during the term of the agreement, both contractually and practically because BOI has exclusive exploration rights in that geographical area.

Is the power criterion met? Yes

Although DrillCo operates the drilling rig, and operating the rig is essential to the efficient use of the rig, the right to operate the rig is dependent on the relevant how and for what purpose decisions the rig is used (which are where to drill, how long for and at what depth, and where to drill next, etc.). BOI is the party that controls those relevant decisions throughout the period of use.

The contract contains a lease and a service (operating the drilling rig).

Note: DrillCo could assess whether the practical expedient to not separate lease and nonlease components is available related to this contract. If DrillCo concludes that the lease component is an operating lease and the nonlease component is delivered to BOI over time consistent with the delivery of the benefit from the lease, then DrillCo would further assess whether the lease component or the nonlease component is predominant. If DrillCo determines that the lease component is predominant, then the combined component is accounted for as a lease under ASC 842. Conversely, if DrillCo determines that the service component is predominant, then the combined component is accounted for as a lease under ASC 606, Revenue from Contracts with Customers.

BOI could also elect to account for the lease and nonlease components as a single lease component under ASC 842.

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