

*Accounting Policy & Practice Report: News Archive*  
2017  
May  
05/12/2017  
BNA Insights

## **New Guidance on Accounting for Leases—Difference Between ASC 842 and 840**



**By Jeffrey Ellis**

*Jeffrey Ellis is a Senior Managing Director at FTI Consulting and is based in Chicago. He has extensive experience advising clients on the accounting for complex transactions and identifying alternative structures to meet client business needs and accounting objectives. Mr. Ellis has assisted law firms on a wide range of matters involving accounting issues, including investigating financial statement restatements and examining structured transactions to determine if the accounting violated generally accepted accounting principles, assisted companies in implementing new accounting standards, and provided advice to companies on financial statement restatements and conversions to International Financial Reporting Standards. In addition, Mr. Ellis has testified as an accounting expert in disputes over leveraged lease transactions.*

*This article is the first in a series exploring the new guidance on accounting for leases (ASC 842) issued by the Financial Accounting Standards Board ("FASB") in February 2016. This article discusses the scope of ASC 842 and highlights ways in which conclusions on whether an arrangement is, or contains, a lease could differ from the conclusions reached under the existing guidance in ASC 840.*

*Subsequent articles will address recognition (including issues around lease classification), initial and subsequent measurement, disclosures and transition.*

*ASC 842 is effective for fiscal years beginning after Dec.15, 2018 (i.e., Jan.1, 2019, for a company with a calendar year end), including interim periods within those fiscal years, for public business entities; not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market; and employee benefit plans that file financial statements with the Securities and Exchange Commission. For all other reporting entities, ASC 842 is effective for fiscal years beginning after Dec. 15, 2019, and is effective for interim periods within fiscal years beginning after Dec.15, 2020. Early adoption of ASC 842 is permitted.*

ASC 842, which was issued in February 2016, significantly changes the accounting for leases by lessees—at least with respect to the presentation of assets and liabilities associated with leases classified as operating leases under the current guidance, ASC 840. However, adopting the new guidance will not be as simple as recognizing an asset and liability for operating leases because, in addition to changing how lessees account for operating leases, FASB also changed **how** leases are identified. ASC 842 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.

In contrast, ASC 840 defines a lease as—an agreement conveying the right to use property, plant or equipment (land and/or depreciable assets) usually for a stated period of time.

While on its face the definition of a lease appears not to have changed in substance, that seeming lack of a change disguises the fact that ASC 842 will change significantly how leases are identified.

Under ASC 842, a contract is, or contains, a lease if the customer (lessee) has the right to obtain substantially all of the economic benefits from the use of the identified property, plant or equipment ("PP&E") and the right to direct the use of the identified PP&E throughout the time that the identified PP&E will be used to fulfill the contract with the customer (lessee).

## **Economic Benefits**

ASC 842 looks at the economic benefits from the use of identified PP&E broadly. The economic benefits include not only the primary output from the asset, but also any by-products and other economic benefits associated with the use of the asset that could be realized from a transaction with a third party. For example, the operation of a solar power or wind farm generates renewable tax credits. The customer would have to be entitled to the renewable tax credits in order to have the right to obtain substantially all of the economic benefits from the use of the solar power or wind farm. Similarly, if a power plant generates steam as a by-product, a customer purchasing electricity generated by the power plant would also have to have the right to the steam (or the electricity generated from the use of the steam) in order to obtain substantially all of the output of the power plant. However, economic benefits that are available based solely on the ownership of the identified PP&E, such as any investment tax credit, won't be considered by the customer in its evaluation of whether it will obtain substantially all of the asset's economic benefits.

## **Right to Direct the Use of Identified PP&E**

A customer has the right to direct the use of identified PP&E if the customer has the right to direct how and for what purpose the asset is used throughout the period of use. To meet this condition, the customer would have to have the right to change how and for what purpose the asset is used. In assessing whether it has that right, the customer would consider the decision-making rights that affect the economic benefits to be derived from using the asset. In general, the right to operate or maintain the asset won't give the customer the right to direct the use of the identified PP&E. ASC 842 provides the following examples of decision-making rights that could grant the customer the right to direct how and for what purpose the asset is used:

- The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit).
- The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used).
- The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed).
- The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

If the decision-making rights relevant to the economic benefits from the identified PP&E have been predetermined, the customer would still be considered to have the right to direct the use of the identified PP&E if the customer either:

- has the right to operate the asset or direct others to operate the asset without the supplier having the right to change the customer's operating instructions,
- or if it designed the asset or specific aspects of the asset in a way that predetermined how and for what purpose the asset would be used throughout the period of use.

Under ASC 840, if the supplier has a substantive right to substitute the identified PP&E throughout the period of use, the arrangement won't be a lease. Under ASC 842, the right to substitute identified PP&E is substantive if the supplier:

- Has the practical ability to substitute alternative assets, and
- Would benefit economically from exercising its right to substitute the asset.

In assessing whether the supplier has a substantive substitution right, a customer wouldn't consider future events that, at the inception of the arrangement, aren't considered likely to occur. If the customer can't readily determine whether the supplier's substitution right is substantive, it is required to presume that the right isn't substantive. Similar to current practice, a supplier's right to substitute an asset is not considered substantive only if the identified PP&E is not operating properly. In general, it would be unusual that a supplier would have substantive substitution rights if the customer controls access to the identified PP&E.

### **Portions of Assets**

ASC 842 provides that a portion of an asset could be the subject of a lease, but only if that portion is physically distinct—such as a floor of a building, an office suite or a segment of a pipeline that connects a customer to a larger pipeline. ASC 840 didn't address whether a portion of an asset could be the subject of a lease. However, many accountants concluded that a contract for an undivided interest in the output from an asset (for example, the right to 50 percent of the electricity from a power plant) could be the subject of a lease. Under ASC 842, an arrangement giving the customer the right to 50 percent of the electricity from a power plant wouldn't be a lease unless that right can be attributed to a physically distinct portion (for example, the capacity from one of the two turbines) in a power plant.

### **Potential Impact of Scope Change**

As noted above, ASC 842 changes the criteria for identifying whether an arrangement is, or contains, a lease from those in ASC 840. In particular, ASC 842 eliminated the following conditions included in ASC 840:

- The customer controls physical access to the identified PP&E and obtains or controls more than a minor amount of the output or other utility of the PP&E.
- The customer has the right to obtain substantially all of the output or other utility that will be produced by the identified PP&E during the term of the arrangement, and the pricing for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output at the time of delivery.

The first condition meant that installing the identified PP&E on the customer's premises (such as with pollution control devices or solar panels) would generally result in the arrangement qualifying as a lease. Under the second condition, an arrangement would qualify as a lease if the customer had the right to substantially all of the economic output of the asset, even if the customer neither operated nor controlled access to the asset—such as an arrangement under which a customer purchases industrial gases from a facility constructed adjacent to its factory and either the customer has contracted for substantially all of the gases produced by the supplier or there are no other potential customers for the industrial gases.

The elimination of these criteria will likely reduce the number of leases identified. For example, under ASC 842, as long as the customer didn't design the pollution control device or solar panels installed on its plant or building and doesn't operate or direct others to operate the pollution control device or solar panels, the arrangement won't be a lease—even though the customer has control over the physical access to the equipment and is obtaining more than a minor amount of the economic output of the equipment. Other arrangements that may no longer qualify as leases once ASC 842 is effective include certain power purchase agreements (particularly for power plants where the customer takes all of the output from the power plant but does not control the dispatch of the plant because it either operates continuously or when temperatures are above or below a certain threshold) and arrangements involving the supply of industrial gases.

## **Examples**

ASC 842 provides 10 examples (many of which address multiple fact patterns), illustrating how to apply the guidance on determining whether a contract is, or contains, a lease. The conclusions to those examples (lease vs. non-lease) and the reasons for those conclusions are largely consistent with the conclusions that would have been obtained by applying the scope criteria in ASC 840 and the rationale for those conclusions. The conclusions to Example 6, Case A (Ship, Contract Does Not Contain a Lease) and Example 9, Case B (Contract for Energy/Power, Contract Does Not Contain a Lease) differ from the conclusions that would have been obtained by applying the scope criteria in ASC 840. In both cases, the arrangements would have been leases under ASC 840 because the customer had obtained the right to substantially all of the output from the identified PP&E. The fact that the destination of the ship (in Example 6, Case A of the lease standard) was specified contractually or that the power plant was designed by the supplier (in Example 9, Case B), which affect the conclusion under ASC 842, were not factors that were considered in determining whether a customer controlled the supplier's asset under ASC 840. The conclusions to Example 9, Case A (Contract for Energy/Power, Contract Contains a Lease) and Case C (Contract Contains a Lease) under ASC 842 are consistent with the conclusions under ASC 840, but the rationale for the conclusions differs. Under ASC 840, the fact that the customer had contracted for substantially all of the economic output of the solar farm or power plant would have led to a conclusion that the contract was a lease (provided that the pricing of the output from the farm/plant was not fixed per unit of output or equal to the market price at the date the power was delivered). Under ASC 842, the customer has to have more involvement to conclude that the arrangement is a lease. In Case A, the customer designed the solar farm; in Case C, the customer has to determine when the power plant operates.

While the examples are helpful in applying the scope criteria in ASC 842, they are also helpful in identifying potential changes to arrangements that could help a reporting entity motivated by accounting considerations avoid accounting for the arrangement as a lease. For example, in Example 9, Case A, if the customer was not entitled to receive the renewable energy credits (or a significant portion of the credits), it wouldn't receive substantially all of the economic benefits from the identified PP&E throughout the term of the arrangement and therefore the arrangement would not qualify as a lease.

## **Conclusion**

While the change to the criteria for determining whether an arrangement is, or contains, a lease won't affect the accounting for a majority of arrangements, it will affect the conclusions reached on a number of common arrangements, and will ultimately lead to classifying fewer of those arrangements as leases under ASC 842, even though the substance of those arrangements has not changed.

*The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.*

ISSN 1947-3923

Copyright © 2017, The Bureau of National Affairs, Inc. Reproduction or redistribution, in whole or in part, and in any form, without express written permission, is prohibited except as permitted by the BNA Copyright Policy.