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# FASB ASC 842: Lease/Non-Lease Component Practical Expedient
## Balancing Financial Reporting Consequences

*By: Thomas Groskopf*

FASB ASC 842-10-15-37 provides a practical expedient to combine lease and non-lease components and treat the combined component as a lease component (practical expedient) which may be elected by underlying class of assets. The FASB provided the practical expedient to relieve cost and administrative burden of allocating consideration based on observable standalone selling prices to separate lease and nonlease components which may be of significant benefit to some lessees. The practical expedient should prove to be a significant benefit to many entities. Importantly, as entities adopt FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases*, some are encountering significant contracts with both lease and non-lease components where delicate financial reporting tradeoffs of election/nonelection of the practical expedient need to be considered. In this report, we will discuss these tradeoffs.

Basis for Conclusion paragraph 150 of Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842) Section A—Leases: Amendments To The FASB Accounting Standards Codification,* indicated that, while the practical expedient is available for all contracts that contain leases, the FASB anticipated that it only would be used for leases with less significant nonlease components. However, adoption of the practical expedient appears widespread including leases with more significant nonlease components. We noted that approximately 75% of a sample of large public companies adopted the practical expedient for all or some asset classes. In that sample, most of those that elected the practical expedient did so for all asset classes. We expect that private company adoption of the practical expedient would be at or above levels seen in our sample of public companies.

Entities may be more inclined to elect the practical expedient for bookkeeping simplicity. Bookkeeping simplicity includes the readily apparent ability to avoid segregating payments between lease and nonlease components but also other less well-known

considerations. For example, for allocation under FASB ASC 842, lessees are unable to follow the contractual stipulation of payments for contracts which have lease and nonlease components with both fixed and variable payments (discussed in a previous report and in a FASB Staff Paper, pgs. 34-46). However, other entities may be motivated to establish observable standalone selling prices as amounts allocated to nonlease service components are not generally capitalized.

We note that decisions regarding election of the practical expedient can have other significant financial reporting consequences which need to be carefully weighed especially for mixed service/lease contracts that, in some cases, are newly uncovered embedded leases. These additional financial reporting consequences include greater lease liabilities than expected, higher likelihood of finance lease treatment, significant impacts on current ratio, and difficult accounting judgments on whether nonlease components are "associated with" lease components. In the remainder of this report, we detail these issues for entities to consider as they contemplate whether to elect the practical expedient for a particular asset class.

FASB ASC 842-10-15-37

As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to 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 lease component.

Newly Uncovered Embedded Leases -- Larger Lease Liabilities

As entities implement FASB ASC 842, many are discovering that some existing contracts are considered leases under FASB ASC 842 but were incorrectly not previously disclosed as leases under FASB ASC 840. A LeaseQuery survey indicated that 58% of entities uncovered embedded leases during their audit preparation. We will refer to these newly discovered leases as "newly uncovered embedded leases." Entities that elect the practical expedient for an underlying class of asset typically will expect a greater lease liability as nonlease service components are recognized on the balance sheet as lease liabilities. However, some entities may be surprised at the magnitude of additional lease liability caused by electing the practical expedient for newly uncovered embedded leases. In our experience, many newly uncovered embedded leases were commonly thought of as service contracts and, therefore, have more significant service components. In other contracts that more prominently feature a leased asset, the service element (such as maintenance) is nominal. In the chart below, we present examples of types of contracts with potentially both lease and more significant service components associated with the lease. It should be noted that, based on contract language, not all of these types of contracts will contain leases and careful contractual analysis is needed to see if a lease

is present under the requirements in FASB ASC 842. If the practical expedient is elected in these cases, contracts with significant fixed payments related to the service components will substantially increase the lease liability.

| Type of Contract | Potential Lease Component?? | Service or Other Nonlease Component |
|---|---|---|
| **Transportation** | Trucks, boats, buses, trains, planes | Crew and maintenance |
| **Marketing/Advertising** | Billboard, advertising sign | Consulting |
| **Outsourced Functions** | Equipment | Inventory, services and repair |
| **Construction** | Cranes, scaffolding | Subcontract labor |

Under FASB ASC 842, only fixed (or in-substance fixed) payments will be capitalized (payments based on a rate or index also are included at the rate or index at the measurement date). However, based on our experience, many entities structure contracts without consideration of this nuance and may operationally desire fixed payments. This can lead to the recognition of a larger lease liability.

EXAMPLE A: Sydney Inc. has a contract with Richards Inc. for freight. The contract provides for 20 trucks, drivers, and maintenance on the trucks. The provisions of the contract are such that the trucks are considered leases under FASB ASC 842. The contract provides for a fixed payment for all goods and services of $1,000,000 for two years. Sydney Inc. elects the practical expedient and records a lease liability of $1,000,000 (0% discount rate used for simplicity).

EXAMPLE B: Same facts as Example A, except instead of a fixed payment of $1,000,000, the contract has a fixed payment of $500,000 and a variable payment based on dollars per mile driven (with no minimum). Based on projections, the total payment will result in a total payment similar to Example A. As Sydney Inc. elects the practical expedient, it records a lease liability of $500,000.

Higher Likelihood of Finance Lease Treatment

If the practical expedient is elected, all nonlease components associated with the lease component are treated “as a single lease component.” Accordingly, any lease payments which may have been allocated to the nonlease component are treated as a lease payment. As a result, the lease payments for purposes of the present value test for

finance lease classification under FASB ASC 842-10-25-2 (commonly known as the 90% present value test) will likely be higher than if the practical expedient was not elected. Therefore, since the fair value of the underlying leased asset remains the same, it is more likely that the lease will be classified as a finance lease. We think this is particularly the case with the types of mixed lease/service contracts previously unrecognized as leases discussed above.

EXAMPLE C: Same facts as Example A, the fair value of the underlying assets is $750,000. Since the lease payments are $1,000,000, the lease satisfies the present value test under FASB ASC 842-10-25-2 and is treated as a finance lease. Note that FASB ASC 842, unlike FASB ASC 840 (with the same title), does not address right of use assets that are greater than the fair value of the underlying asset. While this right of use asset is subject to impairment under FASB ASC 360, *Property, Plant, and Equipment,* such an impairment test is trigger based and the right of use asset is likely to be included with other assets in the asset group.

EXAMPLE D: Same facts as Example B, the fair value of the underlying assets is $750,000. The lease does not satisfy the present value test under FASB ASC 842-10-25-2 or any other classification criteria to be treated as a finance lease. Therefore, the lease is treated as an operating lease.

***CPEA Observation**:* Under FASB ASC 842, both finance lease liabilities and operating lease liabilities are recognized on the balance sheet. However, the income statement pattern of recognition is different. Consistent with capital leases under FASB ASC 840, FASB ASC 842 finance lease expense pattern of recognition is front-ended. This is due to higher amounts being recognized as interest expense under the effective interest method in the earlier years of a lease.

Significant Impacts on Current Ratio

Under FASB ASC 842-20-45-1, generally, entities will present a current portion of operating lease liabilities. However, the operating lease right of use asset will be in noncurrent assets in total. If the practical expedient is elected, since nonlease components associated with the lease component are treated “as a single lease component” the entity will need to present additional lease payments as current operating lease liabilities. Some contracts which were previously unrecognized embedded leases have significant fixed payments related to both lease and nonlease components.

EXAMPLE E: Same facts as Example A, $500,000 of payments are due in the next 12 months under the contract after the balance sheet date (and do not meet any other exception for noncurrent classification). Accordingly, $500,000 is presented as a current liability.

EXAMPLE F: Same facts as Example B, $250,000 of payments are due in the next 12 months under the contract after the balance sheet date (and do not meet any other exception for noncurrent classification). Accordingly, $250,000 is presented as a current liability.

Short-Term Lease Exception??

For some types of mixed service/lease contracts, we find that the ability or inability to use the short-term lease exception under FASB ASC 842-20-25-2 can have dramatic financial reporting consequences in lease liabilities (and current lease liabilities) recognized. Typically, these types of contracts are over shorter terms and more flexible in terms of contract structuring. However, many private companies are not aware of the nuances in financial reporting when contracts are executed and are not able to control the financial reporting results. Private companies that arrange mixed service/lease contracts with more than 12-month lease terms and fixed consideration are more likely to have the financial reporting consequences in Examples A, C, and E. Longer fixed consideration may have operational benefits (especially in inflationary environments) that may need to be weighed with less favorable financial reporting consequences. Unfortunately, widespread procrastination of FASB ASC 842 adoption likely means many situations are closed fact patterns which preclude thoughtful, proactive consideration of appropriate contract structuring.

***CPEA Observation:*** While contracts that can use the short-term lease exception are able to avoid balance sheet recognition and measurement, disclosure of short-term lease expense is required for all leases that have a lease term greater than one month. Accordingly, if the practical expedient is not elected, allocation between lease and nonlease components will be necessary for leases (with a lease term greater than one month) that apply the short-term lease exception for disclosure only. For most private companies, however, the disclosure for short-term lease expense is a once-a-year exercise.

Judgments on Whether Nonlease Components are “Associated With” Lease Components

The practical expedient allows entities to “account for each separate lease component and the nonlease components *associated with* that lease component as a single lease component.” (emphasis added). The practical expedient does not explicitly address how to account for nonlease components NOT associated with a lease component. Also,

unaddressed is how to determine whether a nonlease component is "associated with" a lease component. As a result, when the practical expedient is elected, entities will need to make judgments on the identification and accounting for nonlease components that are not "associated with" the lease component.

EXAMPLE G: Same facts as Example A, except that, in addition to the goods and services in the contract in Example A, the supplier also provides a dispatch service for buses (not for the leased trucks) for an additional contractually stipulated fee of $100,000 for two years. Sydney Inc. needs to make an accounting judgment about whether the dispatch service is "associated with" the leased asset. If the dispatch service is "associated with" the leased asset, the $100,000 would be treated as a lease component and added to the lease liability recognized (since the practical expedient was elected for this contract). If the dispatch service is not "associated with" the lease, the $100,000 would not be accounted for under the practical expedient and would be governed by other applicable FASB ASC standards and not be combined with the lease component under the practical expedient.

*The Meaning of "Associated With"*

Some level of connection should exist for a nonlease component to be "associated with" a lease component. Some look to the nature of the relationship between the lease and nonlease component, while others look at the timing of expense recognition.

KPMG's Leases Handbook indicates (pgs. 214-215) that-

> One approach we believe may be acceptable in making this evaluation (there may be others) is to consider the nature of the relationship between the lease and the non-lease component; this includes how dependent the lessee's ability to use or derive benefit from the non-lease good(s) or service(s) is on the lease.
>
> The following are example considerations that may be relevant in this assessment (not exhaustive).
>
> — A 'yes' to the following questions may suggest that the non-lease component is associated with the lease.
>
> > — Must non-lease goods purchased in a lease contract be used with or consumed by the underlying asset?
> >
> > — Must services purchased in a lease contract be performed on or using the leased asset?
>
> — In contrast, a 'yes' to the following questions may suggest that the nonlease component is not associated with the lease.

— Could the lessee use the non-lease goods with a different asset – e.g. use purchased supplies with an owned asset rather than the asset leased from the lessor?

— Could the lessee direct the lessor to perform the contracted services on an asset other than the asset leased from the lessor – e.g. direct the lessor to perform maintenance on one of the lessee's owned assets instead of the asset leased from the lessor?

PWC's Leases Guide describes (pg. 2-35) another approach-

> We believe a lessee applying this practical expedient should combine the nonlease component only when it would otherwise recognize the cost associated with both the lease and nonlease components in a similar fashion (i.e., either when both are capitalized or when both are expensed). For example, in a contract manufacturing arrangement, a lessee could combine the procurement of raw materials and the lease of production equipment when both components are included in the lessee's inventory costing system and capitalized into the measurement of inventory costs. However, we do not believe a lessee should combine, for example, chemicals purchased for resale into the lease of a pipeline from the chemical supplier, as doing so would distort the lessee's reporting of inventory and cost of sales.

***CPEA Observation:*** Once entities become familiar with the complexities and nuances in this report, they may be tempted to structure nonlease components in separate contracts. FASB ASC 842 does limit this ability to some extent, by requiring some separately entered contracts to be combined for financial reporting purposes using the contract combination guidance in FASB ASC 606, *Revenue from Contracts with Customers,* in FASB ASC 842-10-25-19. However, this would only apply to contracts with the same supplier (or related party of the supplier) which are entered into "at or near the same time" which meet other criteria as well. Entities could avoid this restriction by entering into separate contracts with unrelated suppliers, but this could have economic tradeoffs.

<u>What is Meant by "Class of Underlying Asset"?</u>

The practical expedient is elected by "underlying class of asset." However, the term "class of underlying asset" is not defined by the FASB ASC. Most think of the "class of underlying asset" based on its physical characteristics such as real estate, automobiles, computers, copiers, etc. We feel that this is a viable interpretation. However, some feel that "class of underlying asset" also can be determined based on risk characteristics. For example, while real estate would be one potential "class of underlying asset" based on physical characteristics, the risk characteristics of office space real estate will be different than retail store real estate. Therefore, some feel that "underlying class of asset" should

be applied based on risk characteristics. At present, we feel either view is acceptable as an accounting policy election. Our view is supported by comments by an FASB Board Member who stated at a September 15, 2021 Board meeting that the class of underlying asset concept was not necessarily "prescribed" and further indicated that entities have "some flexibility in granularity of determining" class of underlying assets. (FASB Board Meeting 9/15/21, 9:05).

In general, we note that asset class determinations based on risk characteristics likely will be more disaggregated as compared to physical characteristics. Given the significance of the financial reporting consequences discussed above, additional flexibility that preparers have may be useful.

Conclusion

The practical expedient is beneficial for entities to simplify recordkeeping with numerous types of contracts that contain lease and nonlease components. The well-known tradeoff with making this election is a larger reported lease liability. However, other tradeoffs may need to be considered in some cases including more significant than anticipated reported lease liabilities, finance lease treatment, negative impacts on current ratio, and accounting judgments on the undefined terms "underlying class of asset" and "associated with." In our view, private companies will need to be educated on the tradeoffs in vendor negotiations. Over time, private companies will integrate these tradeoffs in the negotiations process (similar to how the FASB ASC 840 lease classification criteria was integrated into negotiations). The wise will anticipate, the unwise will learn through experience.