

# Identification of Leases Under the New Leasing Standard

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*Keywords: identification of leases, right-of-use asset, lease liability, new leasing standard*

## INTRODUCTION

The Financial Accounting Standards Board (FASB) issued significantly revised standard on lease accounting in 2016. The new standard became effective for annual reporting periods beginning after December 15, 2018, including interim reporting periods within those reporting periods for public business entities. The effective dates of the new leasing standard for private companies have been delayed twice. For private companies, the new leasing standard is now effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted for all entities.

Under the new standard, a lessee recognizes a right-of-use asset and a lease liability for all leases, including operating leases with a term greater than 12 months, which will significantly increase the reported assets and liabilities for many lessees. The critical accounting determination is whether or not a contract is/contains a lease. This determination becomes the new on- or off-balance sheet test. According to the new standard, which was codified in FASB Accounting Standard Codification (ASC) 842, *Leases*, a “contract is or contains a lease if the contract 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.” (ASC 842-10-15-3)

The definition of a lease under the new standard is not much different than under the old standard. But the financial statement impact of failing to appropriately identify a lease under the new standard could be more significant as all leases, including operating leases with a term greater than 12 months, are now reported on the balance sheet. Under the old standard, operating leases and contracts that may contain leases were expensed in a similar fashion. As a result, companies may not have been rigorous about identifying embedded leases in the past. The new standard is expected to have an impact on companies in many

industries. From manufacturing to retailing and healthcare to financial services, nearly all companies enter into lease arrangements.

A lease conveys the right to control the use of an identified asset for a period of time. Arrangements that are perpetual in nature would not meet the definition of a lease because there is no defined period of use. These arrangements are similar to acquiring an asset, and therefore, would be outside the scope of the leasing standard. Arrangements involving intangible assets, the exploration for or the use of minerals, oil, natural gas, and similar nonregenerative resources, biological assets, inventory, and assets under construction are outside the scope of the new leasing standard. (ASC 842-10-15-1)

The lessee has to have the right to control the use of an identified property, plant, or equipment (an identified asset). (ASC 842-10-15-3) Therefore, the two conditions for the contract to be or contain a lease is (a) there is an identified property, plant or equipment (an identified asset) and (b) the customer has the right to control the use of the identified asset.

## **AN IDENTIFIED ASSET**

To identify leases, the first thing is to determine if there is an identified asset in the contract regardless of whether the asset is specified in the contract explicitly or implicitly. To be an identified asset, there are two conditions: (a) the supplier of the asset does not have a substantive substitution right and (b) the asset is physically distinct or the customer has rights to substantially all of the asset's capacity. (ASC 842-10-15-9 to ASC 842-10-15-16)

### **Substitution Rights**

A customer does not have the right to use an identified asset, meaning that, the asset used by the customer is not considered to be an identified asset "if the supplier has the substantive right to substitute the asset throughout the period of use" and the supplier's right to substitute an asset is substantive only if both (a) the supplier has the practical ability to substitute alternative assets throughout the period of use and (b) the supplier will benefit economically from the exercise of its right to substitute the asset. (ASC 842-10-15-10) Both conditions have to be met in order for the supplier to have a substantive substitution right. It is important to note that the conditions include that the supplier will benefit economically from the substitution of the asset. Thus, substantive right to substitute is more than just the supplier's ability to substitute; the supplier must also benefit economically from the substitution. In other words, the cost of substitution must be less than the benefit of substitution for the supplier. The evaluation of whether a supplier's substitution right is substantive is made at the inception of the contract and will "exclude consideration of future events that, at inception, are not considered likely to occur." (ASC 842-10-15-11) When a supplier has a right or an obligation to substitute the asset only before, on or after either (a) a particular date within the period of use or (b) the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use. As such, the substitution right is not considered to be substantive. (ASC 842-10-15-13) A customer will presume that any substitution right is not substantive if the customer cannot readily determine whether the supplier has a substantive substitution right. (ASC 842-10-15-15) Stated alternatively, the presumption is that the supplier does not have a substantive substitution right.

#### *Example 1: Supplier With Substantive Substitution Rights*

Warehouse operator W owns a large warehouse that can be subdivided into numerous storage units. Customer C contracts with W to reserve 2,000 square feet of space to store its equipment for a five-year period. The contract states that C's equipment will be stored in a specified location in the warehouse. However, W has the right to shift C's equipment to another location within its warehouse at its discretion, subject to the requirement to provide 2,000 square feet for the five-year period. W frequently reorganizes its space to meet the needs of new customers. The cost of reallocating space is low compared to the benefits of being able to accommodate as many customers as possible in the warehouse. In this case, while the contract explicitly specifies the location where C's equipment will be stored, W has the unilateral right to

relocate C's equipment. W would benefit by relocating the customer's equipment and can do so without significant cost. As such, W's substitution rights are considered substantive.

*Example 2: Supplier Without Substantive Substitution Rights*

Assume the same facts as Example 1 except that C specified in the contract that its equipment must be stored at a specific temperature and W has only one location in its warehouse with a cooling system capable of maintaining the required temperature. In this case, W does not have a substantive substitution right because W does not have the unilateral right to relocate C's equipment without the significant cost of installing additional cooling systems.

*Example 3: Supplier Without Substantive Substitution Rights*

Assume the same facts as Example 1 except that W only had the ability to shift C's equipment to another location within its warehouse for the first two years of the agreement, instead of during the full five-year contract term. In this case, the substitution right is considered to be not substantive because it does not exist throughout the period of use.

**Physically Distinct**

A capacity portion of an asset can be an identified asset if it is physically distinct. A capacity or other portion of an asset that is not physically distinct cannot be an identified asset, unless it represents "substantially all" of the capacity of the asset. (ASC 842-10-15-16) Although the lease standard does not define what "substantially all" means in the context of the definition of a lease, it uses the same terminology in one of the criteria used to determine lease classification. That criterion is whether the present value of the sum of the lease payments and residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the asset. (ASC 842-10-25-2) In that case, the implementation guidance of the standard states that one acceptable approach to assessing that criterion is to conclude that 90 percent or more of the fair value of the underlying asset amounts to substantially all of the fair value of the underlying asset. (ASC 842-10-55-2) Therefore, it is logical that an entity should also use 90 percent as its benchmark in the context of determining whether a capacity portion of an asset represents an identified asset. In other words, if the capacity being used by the customer is 90 percent or more of the asset's total capacity, the customer is using substantially all of the capacity of the asset and the capacity portion can represent an identified asset. Entities should consult with their auditors if they are considering the use of a different percentage threshold for this purpose.

*Example 4: Rights to a Capacity Portion – Not Physically Distinct*

Customer C enters into an arrangement with a warehouse operator W for the right to store its products in a storage warehouse. W has no substitution rights. However, the arrangement allows W to store products from other customers in the same storage warehouse. The exact space to be used by C within the storage warehouse is not specified. Instead, W decides where each customer's products are stored within the storage warehouse and can relocate them at its sole discretion. C has storage rights that permit it to use up to 60% of the capacity of the storage warehouse. W can use the other 40% of the warehouse as it sees fit. In this example, there is not an identified asset because C has rights only to a capacity portion of the storage warehouse that is not physically distinct from the remainder of the warehouse and the capacity of the storage warehouse that C has the right to use does not represent substantially all of the capacity of the storage warehouse. On the other hand, if C contracts for at least 90% of the capacity of the storage warehouse, the contract will satisfy the substantially all criterion and there will be an identified asset since W has no substantive substitution right.

*Example 5: Rights to a Capacity Portion – Physically Distinct*

Changing the facts of Example 4, the contract provides Customer C the right to use a specific separate room within the storage warehouse, and warehouse operator W has no substantive right to substitute alternative space in place of the specific room. The specific room represents only 60% of the total capacity

of the storage warehouse. In this example, there is an identified asset even though the specific room represents only 60% of the storage warehouse's total capacity. This is because the room is specified in the contract and is physically distinct from other storage locations within the warehouse and W has no substantive substitution right.

## **RIGHT TO CONTROL THE USE OF AN IDENTIFIED ASSET**

When it is determined that there is an identified asset, the next step is to determine whether the customer has the right to control the use of the identified asset. The right to control the use of an identified asset consists of two conditions: (a) "the right to obtain substantially all the economic benefits from use of the asset throughout the period of use" (ASC 842-10-15-17) and (b) "the right to direct the use of an identified asset throughout the period of use." (ASC 842-10-15-20) Both conditions have to be met in order to have the right to control the use of an identified asset. If there is an identified asset in the contract and the customer has the right to control the use of the identified asset throughout the period of use then the contract is or contains a lease.

### **Right to Obtain Substantially All the Economic Benefits**

As stated in the discussion of physically distinct, the lease standard does not define what 'substantially all' means in the context of the definition of a lease. The lease standard uses the same terminology in one of the criteria used to determine lease classification and the implementation guidance of the standard states that it is acceptable to use 90 percent as substantially all in that classification criterion. Therefore, it is believed that an entity should also use 90 percent as its benchmark in evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset.

#### *Example 6: Obtaining Substantially All the Economic Benefits*

Customer C enters into a contract with a telecommunications company T for internet access. T delivers the internet access via an internet router that is specified in the contract. The router broadcasts wireless internet via a secure signal to C and other internet customers. C does not have exclusive use of the output from the router. Therefore, unless the economic benefits that can be derived from use of the router in broadcasting signals to other customers are insignificant in relation to the economic benefits that can be derived from use of the router overall, C does not have the right to obtain substantially all of the economic benefits from use of the router.

### **Right to Direct the Use of an Identified Asset**

The condition that the customer has the right to direct the use of an identified asset is satisfied when the customer has the right to direct how and for what purpose the asset is used or when the decision about how and for what purpose the asset is used are predetermined then either (i) the customer has the right to operate the asset without the supplier having the right to change those operating instructions or (ii) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. (ASC 842-10-15-20)

The right to direct how and for what purpose the asset is used generally includes the right to change the type of the output produced by the asset, when the output is produced, where the output is produced and whether the output is produced and the quantity of the output. (ASC 842-10-15-20). The following two examples adapted from the implementation guidance of the lease standard illustrate the concept of the right to direct the use of an identified asset. (ASC 842-10-55-112 to ASC 842-10-55-122)

#### *Example 7: Right to Direct the Use of an Asset*

Customer C enters into a contract with Supplier S to purchase all of the power produced by an explicitly specified power plant for five years. The contract states that C has rights to all of the power produced by the power plant. C issues instructions to S about the quantity and timing of the delivery of power. If the

power plant is not producing power for C, it does not operate. Supplier operates and maintains the power plant. (ASC 842-10-55-117 to ASC 842-10-55-119)

C has the right to direct the use of the power plant. C has the right to make decisions about how and for what purpose the power plant is used because it has the right to determine whether, when, and how much power the power plant will produce. Because S is prevented from using the power plant for another purpose, C's decision making about the timing and quantity of power produced determines when and whether the power plant produces output. (ASC 842-10-55-122)

*Example 8: Does Not Have the Right to Direct the Use of an Asset*

Customer C enters into a contract with Supplier S to purchase all of the power produced by an explicitly specified power plant for five years. The power plant is owned and operated by S. S is unable to provide power to C from another plant. The contract sets out the quantity and timing of power that the power plant will produce. S operates and maintains the power plant. S designed the power plant when it was constructed some years before entering into the contract with C. C was not involved in the design of the power plant. (ASC 842-10-55-112)

C does not have the right to direct how and for what purpose the power plant is used. How and for what purpose the power plant is used are predetermined in the contract. C has no right to change how and for what purpose the power plant is used. C does not operate the power plant and did not design the power plant. S is the only party that can make decisions about the power plant by making the decisions about how the power plant is operated and maintained. (ASC 842-10-55-116)

## **CONCLUSION**

Under the new leasing standard, a lessee recognizes a right-of-use asset and a lease liability for all leases, including operating leases with a term greater than 12 months. The critical accounting determination is whether or not a contract is or contains a lease. This determination becomes the new on- or off-balance sheet test. According to the new standard, a contract is or contains a lease if the contract conveys the right to control the use of an identified asset. This paper discusses the concepts of identified assets and of the right to control the use of an asset. Examples are used to illustrate the application of the concepts.