CHAPTER THREE

Definitions and Common Guidance

Introduction

IFRS 16 and ASC 842 represent major changes to the lease accounting environment in the sense that lessees now must capitalize all leases in the balance sheet. The changes to the underlying processes, concepts and definitions that lessees and lessors must apply when accounting for leases, however, are much less pronounced.

This chapter examines the general definitions and accounting requirements, such as lease payments and term, that are common to both lessors and lessees. These definitions and requirements serve as an essential foundation for application of the other lessee and lessor elements of the Standards that are discussed in separate chapters. Topics addressed in this chapter include:

- » Key Definitions and Terminology
- » Lease Classification
- » Lease Classification under 842
- » Separating Lease and Non-lease Components

Key Definitions and Terminology

The requirements and processes for classifying and recording leases in lessee and lessor financial statements are heavily dependent on the definitions and terminology associated with those leases. What exactly do lease term and lease payments mean, for example, when recognizing a lessee's liability to make lease payments? These and other terms are examined in detail in this section.

LEASE COMMENCEMENT

The commencement date of the lease is the date the lessor makes the asset available for use by the lessee and is used for many purposes. The commencement date is different than the lease inception date, which is the date on which the agreement is signed. Changes in the accounting treatment of the lease after the commencement date are inappropriate unless the lease is changed through a renegotiation of the terms of the lease.

Lessors and lessees evaluate whether the arrangement is, or contains, a lease on the commencement date and, when applicable, classify the lease as finance or operating on this date. The inputs used to measure the lease, such as fair value and discount rate, also are determined at the commencement date.

This is a change from prior guidance, under which the lease was classified at lease inception based on the inputs at that date. The requirement that a lease initially be measured at lease commencement, however, remains the same under both prior and current guidance. The timing of when lease payments begin, or are paid, does not affect the commencement date of the lease, although any significant rights or obligations created before lease commencement should be disclosed.

LEASE PAYMENTS

Lease payments include all the payments the lessee is obligated to make, or can be required to make, in connection with securing the right to use the leased property. From the standpoint of the lessor, lease payments include all such payments to be received by the lessor.

The basic lease payments required by the lease contract are considered, of course, as lease payments. However, if the basic lease term is extended for any of the reasons listed in the lease term discussion, the additional payments attributable to that extended term also are considered lease payments.

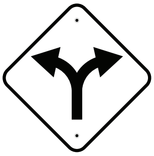
Costs necessary to securing the asset (e.g., insurance, real estate taxes) paid by the lessee to the lessor should be included in lease payments, although these payments generally are variable payments. Those payments made directly to the taxing authority and/or insurance provider by the lessee would not be considered lease payments by the lessor.

The following are specific examples of lease payments.

» Fixed payments (including in-substance fixed payments), less any lease incentives

- » Variable lease payments that depend on an index or rate, initially measured using the index or rate at the lease commencement date
- » The exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- » Penalties paid to terminate the lease, if it is reasonably certain the lessee will exercise the option to terminate the lease
- » Amounts the lessee expects to pay under residual value guarantees
- » The lessor includes any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor.

A Different Path



ASC 842 also includes fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees are not included in the fair value of the underlying asset for purposes of the present value classification test.

Lease payments do not include payments allocated to the non-lease components of a contract or guarantees by the lessee of the lessor's debt. An exception to the first exclusion would be when the lessee elects to combine non-lease and lease components and to account for them as a single lease component.

Lease payments also do not include the costs to restore the underlying asset, if modified by the lessee, to its original condition. Costs imposed by the terms and conditions of the lease agreement to dismantle and remove the asset at the end of the lease term, on the other hand, are included in lease payments.

Variable payments

Variable payments are those lease payments made by a lessee that vary because of changes in identified factors, other than the passage of time, that occur after the commencement date of the lease. Variable payments not based on an index or rate are excluded from the definition of lease payments. These payments are off the balance sheet of the lessee and not recorded as part of the lessor's net investment in a finance lease. They are recorded as lease expense or income, respectively, as they arise.

As an example of a variable payment, a captive medical equipment lessor's customer may request a consumption-based services model in which the payment is tied to actual utilization of the underlying asset, plus any disposables or other services related to that utilization. This is not to say that the lessor does not have any expectation of what the total payment will be – economically, it establishes the variable payment based on historical and anticipated use of the asset.

Other examples include payments based on miles or kilometers traveled, copies made, or kilowatts taken. In transactions such as these, the lease component of the variable payment that is not linked to an index is not considered a lease payment. The lessee is not required to recognize costs from variable lease payments in the balance sheet, even if it is probable that the variable payments will occur, nor should the probability of occurrence be assessed throughout the lease term.

A Different Path

ASC 842 may require lessees to recognize variable payments if achievement of the triggering target is considered probable, depending on how the variable payment is measured. For example, a variable payment for an imaging device that is triggered upon reaching a cumulative usage benchmark of 10,000 copies, should be recorded and recognized over the lease term if achievement of that benchmark is deemed probable and, correspondingly, reversed if it becomes probable the benchmark will not be met.

A variable payment that is triggered as utilization occurs, on the other hand, would not be recorded under either standard, even if a certain level of utilization by the lessee is anticipated.

Another issue associated with significant or wholly variable lease payments is the calculation of the lessor's implicit rate in the lease. The implicit rate in a finance[1] lease in which a significant portion of the lessor's return is due to significant variable payments will be negative. This occurs because the net investment in the lease, which is a function, in part, of the amount of the lease payments, is less than the carrying amount of the asset.

Lessee guaranteed residuals

Any guarantee of the residual by the lessee, or a related party, must be considered when determining the lease payments. This is true whether the guarantee requires the lessee to purchase the leased property or not. The lessor's right to require the lessee to purchase equipment at the end of the lease for a stated amount is a residual guarantee. A provision requiring the lessee to make up a residual value shortfall attributable to damage, or excessive use is not considered a residual guarantee, as it is akin to a variable lease payment.

A residual guarantee also exists when the lessee agrees to make up any deficiency in the residual value below a stated amount. A lessee may agree to make up any deficiency in the residual value realized by the lessor in order to obtain more favorable lease rates, for example. The following illustrates the mechanics of such a guarantee.

Assume that the lessee has guaranteed to make the lessor whole for any residual amounts the lessor realizes below the guarantee of 50,000. If, at the end of the lease, the lessor received 43,000 for the residual in an orderly market transaction, the lessee would owe the lessor 7,000 (50,000 stated amount – 43,000 realized amount).

Under prior guidance, the amount of the maximum potential deficiency (50,000 in the above example) had to be recognized as a lease payment in the lessee's accounting, even though the lessee may not have expected to pay, or actually paid, the full amount of the guarantee. Recognition of the maximum potential deficiency is not required

[1] The term 'finance lease', unless specifically referencing IFRS 16, is meant to encompass finance leases under IFRS 16 and sales-type and direct financing leases under ASC 842.

under the Standards, however, as they state that lease payments include amounts **expected** to be payable by the lessee under residual value guarantees.[2]

A lessee must assess, therefore, what it expects to pay under the residual guarantee and recognize that amount as a lease payment. Referring to the prior example, if the lessee was confident that the fair value of the residual would not fall below 49,000, it would only include 1,000 in lease payments (50,000 stated amount – 49,000 expected value). If that expectation changes during the term of the lease, the lessee must reflect that change by revising the lease payments.

Should a lessee choose to mitigate its risk associated with the residual by obtaining a residual value guarantee from an unrelated third party, it should not reduce the amount of its own residual guarantee, unless the lessor explicitly releases the lessee from that primary obligation. Amounts paid by the lessee for a third-party residual guarantee are not included in the lessee's lease payments.

Bargain purchase options

A bargain purchase option is a provision allowing the lessee, at its option, to purchase the leased property for a very low price relative to its expected fair value at the date the option becomes exercisable. Since, in such circumstances, the exercise of the option appears, at lease commencement, to be reasonably assured, the bargain purchase option is included in lease payments.

Bargain purchase options are considered lease payments as they are reasonably certain of being exercised, not probable of being exercised. This distinction is important, as this criterion measures whether the lessee will obtain ownership of the asset, not whether it is possible it will obtain that ownership.

Who determines whether or not a particular purchase option is low enough to be considered a bargain? It is the responsibility of the lessor and lessee to individually make this determination, based on their own best estimates of future events and

[2] The full amount of the guarantee must be used in the lessee's present value classification test under ASC 842, however.

asset values. The company's auditor, however, through the audit process, passes final judgment as to the appropriateness of the determination.

Refundable security deposits

Refundable security deposits are amounts paid to the lessor by the lessee as security for the fulfillment of its obligations outlined in the lease agreement. They may, or may not, bear interest and some are held in escrow. Refundable security deposits typically are returned to the lessee at the end of the lease term, either in cash or as a payment to purchase the equipment for a specified amount.

Although refundable security deposits improve the lessor's yield in a transaction, they are not considered lease payments and, therefore, are not included in the lessee's recognition of the lease, the lessor's calculation of the implicit rate in the lease or the present value classification test. Refundable security deposits represent a liability of the lessor but are not netted against the net investment in the lease and any interest income earned on them is shown in other income.

Penalties

Lease payments include any payment, such as penalties, the lessee must, or can be required to, make if it does not renew or extend the lease. This requirement interacts with the guaranteed residual and lease term definitions and how they relate to lease payments.

For instance, if the required payment is a purchase of the leased property, it essentially acts as a guaranteed residual and is included in lease payments. Penalties also impact the determination of the lease term, as the lease term includes any periods for which failure to renew the lease imposes a penalty significant enough that, at lease commencement, renewal appears to be reasonably assured.

Consider a three-year lease of a machine tool, with a fair value of 200,000, that has a one-year renewal option. If the lessee does not exercise the renewal option, it must pay a nonrenewal penalty of 100,000. The amount of the penalty in this example is significant, indicating that the lessee most likely will renew the lease rather than incur the penalty, thereby making it a four-year lease for accounting purposes.

Since the lease term has been extended due to the penalty provision, the related penalty is not included in the lease payments, as it is not expected to be paid. If, however, the nonrenewal penalty was 1,000, the lessee is not reasonably assured of renewing the lease, as the penalty is insignificant. In this case, the lease is a three-year lease for accounting purposes and the 1,000 is considered a lease payment.

A penalty can take many forms and can be imposed by the lease agreement or by outside factors. The penalty may require the lessee to disburse cash, incur or assume a liability, perform services, forego an economic benefit, or suffer an economic detriment. Factors such as the following should be considered when assessing the significance of an economic detriment.

- The uniqueness or location of the asset
- The availability of similar replacement assets
- The significance of the asset to the lessee's continuing operations
- The existence of significant leasehold improvements
- Adverse tax consequences
- Relocation or replacement costs

LEASE TERM

The Standards define the lease term as the noncancelable period of the lease, together with:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

A lease is considered noncancelable if it is cancelable only upon the occurrence of some remote contingency, only with the lessor's permission, or only if the lessee enters into a new lease with the same lessor.

At the commencement date, each party must assess whether the lessee is reasonably certain to exercise any renewal or termination options in the agreement. All factors that may create an economic incentive for the lessee to exercise, or not to exercise, the option should be considered, including any expected changes in facts and circumstances from the lease commencement date until the exercise date of the option.

Options to extend the lease

A bargain renewal option is an option to renew the lease in which the renewal payments are so far below fair market value, or normal rentals for the same equipment, that the lessee is reasonably certain to renew. Because renewal is reasonably assured, the period of the bargain renewal option is considered part of the overall lease term. It is the responsibility of the lessor and lessee to separately decide whether a renewal option is a bargain.

One also must consider renewal periods preceding a bargain purchase option when determining the lease term. The lease term is extended to include any time period prior to a bargain purchase option. In this case, the assumption is made that the lessee is reasonably certain to remain in the lease at least that long because, by doing so, the asset can be acquired at a bargain price.

If the lessor has the option, through the lease agreement or a form of economic compulsion, to require the lessee to renew the lease, the lease term also is extended to include that period covered by the lessor's option. Such an option is known as a put option because the lessor can put the lessee in the position of having to renew the lease.

Penalties also can impact the lease term, since the lease term includes any periods for which failure to renew the lease imposes a penalty significant enough that, at lease commencement, renewal of the lease appears reasonably assured. A penalty can take many forms and may be an economic detriment as opposed to a cash payment or assumption of a liability.

An economic detriment, for instance, may include the costs of relocating the asset or finding a replacement asset. Other factors that may be considered in assessing whether a lessee is reasonably certain to exercise a renewal option include how short the firm-term lease is, the lessee's past practices with similar leases, and economic motivations in how it uses the equipment.

An economic motivation for renewing the lease also may exist if the lessee guarantees or provides all or part of the debt used by the lessor to acquire the asset. In this instance, it is assumed that, as long as the lessee is at risk for any of the lessor's debt, the lessee will continue to use the asset and renew the lease for at least that period of time.

Option to terminate the lease

It could be argued that the opportunity to return the asset in a fair market value lease represents a termination option, as does the failure to exercise a renewal option. These are not situations that the Boards contemplated when developing the option to terminate rules, however.

An option to terminate a lease typically would be one such as those in what are known as window leases. A window lease is a variation of a standard fair market value lease that features a cancellation option during the lease term. The option allows the customer to terminate the lease, return the equipment and pay a predetermined termination penalty.

The cancellation option only is available once, on a predetermined date, creating a "window" for the customer to either cancel or continue the lease to expiration. If the customer chooses to continue to the lease expiration, the lease contains end-of-term options to either purchase or renew the lease at fair value or return the equipment.

The concern in transactions such as these is whether the termination option is being used to take the lease off the balance sheet or minimize the impact of the lease on the balance sheet (e.g., the short-term lease exemption). This concern is exacerbated by the fact that lessors oftentimes have used similar structures only when it appears extremely unlikely the customer will exercise the termination option, as early termination can adversely affect the lessor's overall deal economics.

The economic impact of the termination option, therefore, must be carefully assessed in order to determine if the option, from an economic perspective, represents an actual option. If the cancellation fee to terminate the lease, for example, is excessive, it is not likely the lessee will exercise that option, so the lease term must be extended beyond the point of the termination option.

A termination option shortly after the lease commencement date also may not provide a real option at all, as there is an economic detriment to terminating the lease in the form of new negotiation costs to replace the leased asset or find a replacement asset. If the lessee is compelled, in any way, to forego exercise of the termination option, the lease term must be extended beyond the option point.

DISCOUNT RATE

Both lessors and lessees must use a discount rate to record their leases in the financial statements. The discount rate used by lessors, however, is different from the discount rate used by lessees. Lessees and lessors may apply a single discount rate to a portfolio of leases if they can conclude that doing so does not create a material difference from the result using individually determined discount rates applied to each lease.

Lessor

Lessors use the rate implicit in the lease to classify and measure their leases. The implicit rate in the lease is the rate of interest that causes the aggregate present value of the lease payments and residual value to equal the sum of the fair value of the asset and any deferred initial direct costs. The implicit rate measures the lessor's percentage yield or return from an accounting perspective.

A Different Path

When calculating the implicit rate under ASC 842, the fair value of the asset should be reduced by any related investment tax credit (ITC) retained and expected to be realized by the lessor.

In simpler terms, the implicit rate in the lease is the internal rate of return (IRR) of the fair market value (less ITC, if applicable), the lease payments, unguaranteed residuals, and deferred initial costs.[3] This definition does not include all the factors a lessor might recognize in determining its true economic yield from the lease. The implicit rate is defined solely for purposes of accounting for the lease, so it should not be confused with other economic returns.

Another issue associated with calculating the implicit rate arises in leases with significant or wholly variable lease payments. The implicit rate in a lease in which the net investment is less than the carrying amount of the asset will be negative, as was discussed in an earlier section. A finance lease that has a negative implicit rate should not be measured based on that negative implicit rate. Instead, an implicit rate of zero should be used.

Lessee

A lessee computes the present value of the lease payments using its incremental borrowing rate. The lessee's incremental borrowing rate is the interest rate at which a lessee would borrow money to obtain a similar asset, over a similar term, with similar security, and in a similar economic environment.

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[3] A lessor should not defer initial direct costs if, at the lease commencement date, the fair value of the asset is different from its carrying amount.

If the lessee knows, or can determine, the lessor's implicit rate in the lease, and it is less than the lessee's incremental borrowing rate, the implicit rate should be used. It is highly unlikely that the lessee will know the lessor's implicit rate, though, as it would have to know each component of the implicit rate (fair value of the asset, the lessor's estimated residual value and the initial direct costs incurred by the lessor). This rarely occurs, so, as a practical matter, the lessee uses its incremental borrowing rate.

The definition of the incremental borrowing rate refers not just to the length of the lease, but also to other lease parameters or terms, such as fixed rate financing, a down payment or a balloon payment comparable to the residual estimate, etc. Incremental means the borrowing rate should be based on the interest cost to borrow additional funds for this incremental project.

Using LIBOR or short-term government notes (unless as a base to which a spread is added) as the incremental borrowing rate is not appropriate, as these rates do not reflect longer-term borrowing rates. Note that the incremental borrowing rate also is not the lessee's imbedded cost of borrowing.

ESTIMATED ECONOMIC LIFE

The estimated economic life of the leased property is the estimated remaining period during which the property is expected to be economically usable by one or more users. The asset's economic life includes normal repairs and maintenance without limitation by the lease term. In determining the estimated economic life, it is presumed that the asset will be used for the purpose for which it was intended at the lease commencement date.

The estimated economic life should not be based on the depreciable life the lessee uses for tax purposes, as tax lives are based on government investment policies, not the actual useful life of the assets. Nor should the estimated economic life be based on the depreciable life the lessee uses for accounting purposes, as these lives generally represent the anticipated life in the hands of one user, not the multiple users contemplated by the Standards. The lessor and lessee independently determine the economic useful life of the asset.

ESTIMATED RESIDUAL VALUE

The estimated residual value is the lessor's estimate of the fair value of the leased asset at the end of the lease term. Several industries, particularly the auto industry, have enough experience with equipment that they publish anticipated values of used equipment. Such information, when available, may be used by the lessor or the lessee to help in estimating future values of leased assets.

Other lessors and lessees secure residual value estimates from qualified appraisal firms that charge a fee to give appraisals for certain types of assets. Occasionally, insurance companies will guarantee all or a portion of the future estimated value. In any event, the lessor and the lessee independently assess the anticipated value of the asset in order to negotiate the terms of the lease, as well as to account for it.

The value of the estimated residual impacts not only the calculation of the lessor's implicit rate, but also the amount of income to be recognized by the lessor. For either of these two purposes, the estimated residual is that amount estimated at the lease commencement date.

It is expected that the lessor's estimate of future value used for accounting purposes will be the same as the value used for pricing the lease. The Standards do not require that these two amounts be the same, however. The only requirement is that the accounting residual estimate represent the asset's anticipated future fair value. The lessor is free to choose any residual assumption when pricing the lease in order to meet its economic objectives, although auditors like to see symmetry between the accounting and economic residuals.

FAIR VALUE OF THE UNDERLYING ASSET

Fair value is the price for which the property to be leased could be sold in an arm's-length transaction between unrelated parties. This amount is not necessarily the price the lessor pays for the asset, nor a list price quoted by a manufacturer or dealer. It should be viewed as the normal selling price the lessee would pay to purchase the asset.

INITIAL DIRECT COSTS

Certain lessor and lessee costs, known as initial direct costs, incurred to consummate a leasing transaction, are measured and, generally, amortized over the term of the lease. These costs are separated from overhead costs otherwise deducted from income in the month they are accrued. Not all transaction costs are treated in this manner, though.

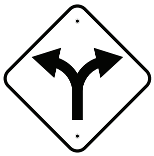
Only those incremental costs of a lease that would not have been incurred if the lease had not been executed may be deferred as initial direct costs. One test to determine if a cost is incremental is to ask whether the cost would have been incurred if either party decided to walk away from the deal just before signing the lease. This definition of initial direct costs is narrower than under prior guidance.

Commissions would be an example of initial direct costs for a lessee or a lessor. Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, on the other hand, are not initial direct costs. The lessor should offset fees and other non-asset related income against the initial direct costs.

Lease Classification

IFRS 16 and ASC 842 require lessees to capitalize all leases in the financial statements. Consequently, there no longer is a need for IFRS 16 lessees to classify their leases as either finance or operating. The distinction between finance and operating leases is retained for lessors under both standards, however.

A Different Path



The FASB retained the distinction between operating and finance leases for lessees, so lessees subject to ASC 842 will continue to classify their leases as either finance or operating. The accounting processes and ramifications of this difference are addressed in Chapter Four, which examines lessee accounting.

The Standards require lessors to classify their leases in order to recognize the economic differences between the different types of lease transactions. The economic substance of an operating lease is very different from that of a finance lease. The characteristics of an operating lease, for example, are those of a usage agreement, or rental. The lessor owns the asset and allows the lessee to use it in exchange for rent payments.

The economic substance of a finance lease, on the other hand, is that of a purchase of the asset by the lessee. The lessor finances the acquisition of the lessee's asset and is repaid over the term of the lease through rent payments. The lessee acts in the capacity of the owner of the asset in such a circumstance.

In practice, there may be enough ambiguity in lease contracts that the intent of the lessor and lessee, as to usage versus ownership, may be unclear. On one extreme, a lease may be intended to simply be a rental of an asset by a lessee to meet a certain short-term need. On the other end of the spectrum, the lease may be intended as a full financing of the asset in the form of a lease due to some accounting, regulatory or managerial need.

The objective of the Standards, therefore, is, in part, to establish where one, from the lessor's standpoint, draws the line between these two extremes. When is the lease a true rental (operating lease) and when is it, instead, a disguised loan, or sale and purchase (finance lease)? The answer to this question is determined through an application of the Standards' lease classification criteria.

CLASSIFICATION CRITERIA

There are five classification criteria that determine how a lease must be classified and accounted for. These criteria generally are referred to as the finance lease criteria because, if any one of them is met by the terms of a lease, the lease is classified as a finance lease. If none of the criteria are met, the lease is classified by the lessor (and ASC 842 lessees) as an operating lease.

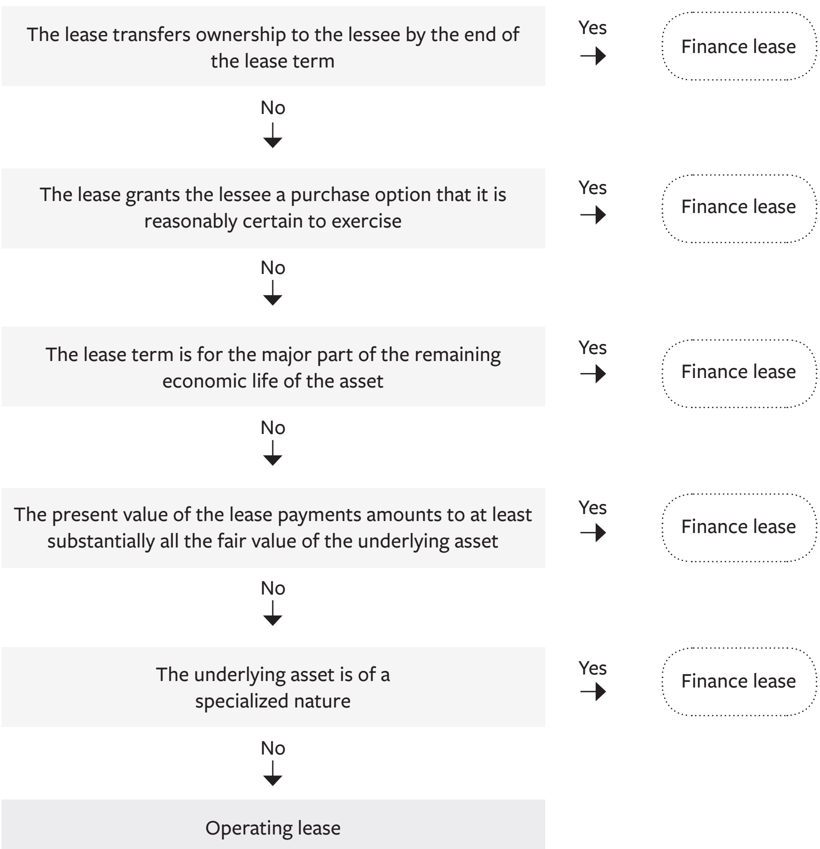
Once the lease is classified, the accounting treatment remains the same throughout the term of the lease unless the contract is modified, and the modification is not accounted for as a separate contract. The lease classification process is illustrated in Figure One.

The Standards require that lease classification be performed on a lease by lease basis, although there may be some circumstances, although infrequent, in which lease classification may be performed on a portfolio basis. This practice, however, should be adopted only when the portfolio includes homogenous leases with similar assets and virtually identical terms.

Transfer of ownership

The first criterion requires the determination of whether the lease automatically transfers ownership of the property to the lessee by, or at, the end of the lease term. Such a transfer is similar to a conditional sales or hire-purchase contract in which title to the asset automatically transfers to the borrower after it makes a specified number of payments.

Figure One | ***Lease Classification***



The transfer of title must be automatic, however, whether it be through the passage of time or payment of a nominal amount. Even if the last payment to transfer title is only 1, the payment must be required in the documentation since, if the lessee has the option to pay the amount or not, the transfer of title no longer is automatic.

If, indeed, the contract does provide for such automatic transfer of title, the transaction is considered to be a purchase in the guise of a lease and hence, is classified as a finance lease. This criterion tests if the lessee has **actual ownership.**

Bargain purchase option

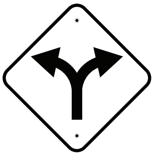
If the lease contains a bargain purchase option, it is treated as a finance lease. If an option allows the lessee to purchase the asset for an amount well below fair value, it is almost certain that the option will be exercised (i.e., no one can pass up a bargain). Furthermore, the only reason a lessor would offer a bargain purchase option to the lessee is because the lessee already has paid for the equipment through the rentals.

This criterion is similar to the first in that title most likely will transfer to the lessee, indicating that the arrangement is, in substance, a purchase agreement. In this case, the lessee has **potential ownership** through the bargain purchase option.

Economic life

The third criterion states that the lease shall be treated as a finance lease if the lease term is for a major part of the remaining economic life of the leased property.[4] This criterion is applied to the predominant asset in the event there is more than one asset in the lease component, subject to the lease component discussion later in this chapter. Furthermore, this criterion would not be applied to land, as it has an unlimited life.

A Different Path



ASC 840 contained bright-line tests for assessing the economic life and present value classification tests. The FASB decided not to require the use of bright-line tests in ASC 842, although, in its implementation guidance, it stated that a reasonable approach to lease classification is to use the bright lines of ASC 840. These bright lines include:

- 75% or more for the economic life test
- 25% for purposes of determining what constitutes “at or near the end of the economic life of the underlying asset” for the economic life test
- 90% or more for the present value test

[4] ASC 842 adds the caveat that, if the commencement date falls at or near the end of the asset’s economic life, this criterion is not used to classify the lease.

> The bright lines must be applied consistently across all leases, however. IFRS 16 does not allow the use of bright line thresholds for lease classification.

In a lease meeting this criterion, the lessee uses the asset for most of its useful life in the same manner as an owner. The lessee is, in substance, acting like the owner, not a short-term renter, of the asset.

In this case, asset exhaustion occurs in the hands of one user. The lessee uses up the asset just the same as if it were to buy it and wear it out. The lessee has achieved **effective ownership** in this case, so it recognizes the right-of-use (ROU) asset and lease obligation in its balance sheet. Correspondingly, the lessor treats the lease as a financing arrangement.

Present value

The Standards' fourth criterion states that, if the present value of the lease payments, at the lease commencement date, amounts to at least substantially all the fair value of the leased property, the lease is a finance lease. The key to this test is the present value.

A basic tenet of finance is that the present value of a series of cash flows represents the principal in those cash flows. This only makes sense, because the present value process removes the interest from the cash flows being present valued – what remains is principal. If the lessee is going to pay substantially all the principal associated with the asset, it **effectively is paying for the asset**, which is what owners do. The lease is accounted for as a finance lease.

Lessors must use the implicit rate in the lease, while ASC 842 lessees use their incremental borrowing rate to discount the lease payments in this test. Although ASC 842 lessees must use the lessor's implicit rate if it is known, and it is lower than their incremental borrowing rate, this rarely will occur in practice.

A Different Path

When evaluating the lease classification criteria under ASC 842, the fair value of the asset should be reduced by any related ITC retained and expected to be realized by the lessor, as these are linked to the ownership of the asset. ASC 842 also indicates that an entity need not consider the present value test if it is not practical to determine the fair value of the asset, although such situations will be rare.

Specialized asset

If the underlying asset is of such a specialized nature that only the lessee can use it without major modifications, the lessee is deemed an **effective owner** and the lease is classified as a finance lease. Economically, a lessor prices the lease to receive the return of its investment only through the lease payments (no residual reliance), if it has no economically viable alternative use for the asset which, again, points to effective ownership by the lessee.

Both contractual and practical restrictions on the lessor's ability to change or redirect the use of the leased asset should be considered when evaluating whether the leased property is expected to have an alternative use to the lessor at the end of the lease term. Is the lessor limited in any way, for instance, in its ability to sell the asset or redeploy it elsewhere with another lessee? In this respect, the fact that there are very few possible buyers for an asset does not mean it is specialized.

A dedicated production line to manufacture a lessee's product to very exact specifications, for example, most likely would, but not always, be considered a specialized asset. Questions that need to be answered when determining if the line is a specialized asset include whether the line has unique design specifications, if it is usable by only the one manufacturer and if there is any market for it at the end of the lease.

If the components of the line, like the robotics or molds, are generic, an argument could be made that the line, although specific to one manufacturer, may, if disassembled, create additional economic benefit beyond the lease term. If the lessor could do so without incurring significant economic losses, the production line may not be a specialized asset.

If the line only can be used by one lessee due to its design, though, or the line has proprietary technology, it will be considered a specialized asset and the lease would be classified as a finance lease. In situations such as these, it is expected the lease will be priced to transfer substantially all the benefits and risks of the asset to the lessee. This expectation creates a presumption that, if the lease contains a fair value purchase option, the assets probably are not specialized. It also allows an argument to be made that, if none of the other four criteria are met, creating a finance lease based solely on this criterion may not be appropriate.

Other classification considerations

The five, finance lease criteria must be applied to all leases, but there are some circumstances that require additional analysis.

Additional factors in the transaction

One of the goals of the Boards in issuing the Standards was to move away from bright-line analyses and make lease accounting more principles-based. In this respect, there are other factors that should be considered, in totality, that might indicate whether substantially all the risks and rewards of an asset have been transferred to the lessee.

What if, for example, the terms of the lease allow the lessee to cancel the lease, but any losses incurred by the lessor as a result of the cancellation are borne by the lessee? A valid conclusion, in conjunction with other elements of the lease, might be that control of the asset has been transferred to the lessee in this situation.

The same conclusion may be reached in certain Terminal Rental Adjustment Clause (TRAC) leases, in which any fluctuation in the fair value of the residual at the end of the lease accrues to the lessee in the form of a rent rebate equaling most of the sales proceeds. Does having downside and upside participation in the residual transfer control of the asset to the lessee in this case? Although the finance lease criteria drive the classification, it also is important to consider other elements such as these when classifying the lease.

Classification reassessment

Once the lease is classified, the accounting treatment generally remains the same throughout the term of the lease. A reassessment may occur, however, if, after lease commencement, there is a change in the assessment of a lease factor such as whether a renewal or purchase option will be exercised.

Another reassessment may be required if the contract is modified, and the modification is not accounted for as a separate contract. The facts at the reassessment date would be used in the classification process in these circumstances.

Acquisitions and business combinations

The classification of a lease acquired in a business combination is not reassessed unless the contract is modified as part of the combination, and the modification is not accounted for as a separate contract. If the acquiree in a business combination is a lessee, the acquirer recognizes ROU assets and lease liabilities for those leases, in accordance with the Standards. The acquirer is not required to recognize short-term leases (based on the acquisition date) or low-value leases, although this latter exception does not exist for ASC 842 acquirers.

Related parties

Leases between related parties are not classified any differently than those between unrelated parties. The same concept applies to measurement and recognition of the leases – the accounting in the separate financial statements of the related parties should be the same as for leases between unrelated parties.

LEASE CLASSIFICATION EXAMPLE

The following example illustrates the lease classification process for lessors and ASC 842 lessees.

EXAMPLE

DMC Finance is leasing equipment to Reidesign Demolition, Ltd., so it can run its projects more effectively. The transaction is a Fair Market Value (FMV) lease that, under its terms, gives Reidesign the option at lease end to return the equipment, buy the equipment at fair value, or renew the lease at fair value. DMC is uncertain as to whether Reidesign will exercise either the purchase or the renewal option.

The following assumptions represent the specific parameters of the lease.

Date the asset is delivered:	April 15
Lease term:	48 months
Payment amount:	2,006.32, in advance
Unguaranteed residual:	10,000
Equipment fair value:	90,000 (which also is the cost)
Implicit rate:	7.7266% (.6439% per month)
Lessor's initial direct costs:	1,500, consisting of a broker fee of 2,000 and a 500 closing fee collected from the lessee
Other considerations:	> DMC bills Reidesign interim rent of 1,003.16, plus the first month's rent of 2,006.32, due on the day the equipment is delivered > The equipment has an economic life of seven years

Classifying the lease

DMC Finance must apply the Standards' five finance lease criteria to the transaction at lease commencement to determine whether it is a finance lease or an operating lease.

» **The lease transfers ownership to the lessee by the end of the lease term** – the lease contains a fair market value purchase option, so this criterion is not met

» **The lease grants the lessee a purchase option that it is reasonably certain to exercise** – the lease contains a fair market value purchase option which DMC is not certain Reidesign will exercise, so this criterion is not met

» **The lease term is for the major part of the remaining economic life of the asset** – the 48-month lease term is less than 75% of the 7-year economic life (84 months), so this criterion is not met. DMC has adopted a benchmark of 75% as representative of a major part of the economic life of an asset. DMC applies this percentage consistently across all its leases.

» **The present value of the lease payments amounts to at least substantially all the fair value of the underlying asset** – the first step in this criterion is to establish the comparison base that represents substantially all the asset's fair value. DMC has adopted a benchmark of 90% as representative of substantially all the asset's fair market value. DMC applies this percentage consistently across all its leases.

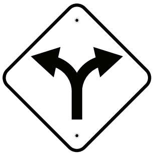
90,000	(fair value)
x 90%	(substantially all benchmark)
81,000	Comparison base

The present value of the lease payments of 84,151.39, including the interim rent and using the 7.7266% implicit rate, is greater than the 81,000 comparison base, so this criterion is met.

» **The underlying asset is of a specialized nature** – it is assumed that the underlying asset is not specialized, so this criterion is not met

One of the five finance lease criteria is met, so DMC records the lease as a finance lease. This lease would be recorded as a sales-type lease under ASC 842, since the risks and rewards of ownership are transferred to the lessee only.

A Different Path



Although IFRS 16 characterizes all lessor, non-operating leases as finance leases, ASC 842 separates non-operating leases into two categories.

- Sales-type leases
- Direct financing leases

A sales-type lease transfers the risks and rewards of ownership only to the lessee. A direct financing lease transfers the risks and rewards of ownership to the lessee and/or an unrelated third party. Consequently, the present value classification test for ASC 842 lessors reflects this distinction.

Lease Classification under ASC 842

Lessees and lessors both must classify their leases under ASC 842, although there are some definitional differences between the IFRS 16 and ASC 842 elements of the classification tests.

LESSEE

ASC 842 requires lessees to distinguish their transactions between operating and finance leases, so lessees subject to ASC 842 will continue to classify their leases according to the classification process illustrated in Figure One of the prior section. There are additional factors, beyond those of IFRS 16, that must be considered.

One of these is the definition of fair value, which should be reduced by any related ITC retained, and expected to be realized, by the lessor.

Another is the application of bright-line tests. For example, although ASC 842 is principle-based and does not contain bright-line tests, the FASB, in its implementation guidance, stated that a reasonable approach to lease classification is to use the bright lines of ASC 840. These bright lines must be applied consistently across all leases and include:

» 75% or more for the economic life test
» 90% or more for the present value test
» 25% for purposes of determining what constitutes “at or near the end of the economic life of the underlying asset” for the economic life test

ASC 842 also requires that the full amount of any guarantee must be used in the lessee’s present value classification test, although only the expected performance under the guarantee is included in lease payments when measuring the lease liability. As an example, assume that an ASC 842 lessee has issued a guarantee to make the lessor whole for any realized residual amounts below 50,000.

For lease classification purposes, the amount of the maximum potential deficiency of 50,000 must be included as a lease payment in the lessee’s present value classification test, even though the lessee may not expect to pay the full amount of the guarantee. For purposes of measuring and recognizing its lease liability, however, the lessee must assess what it expects to pay under the residual guarantee and recognize that amount as a lease payment.

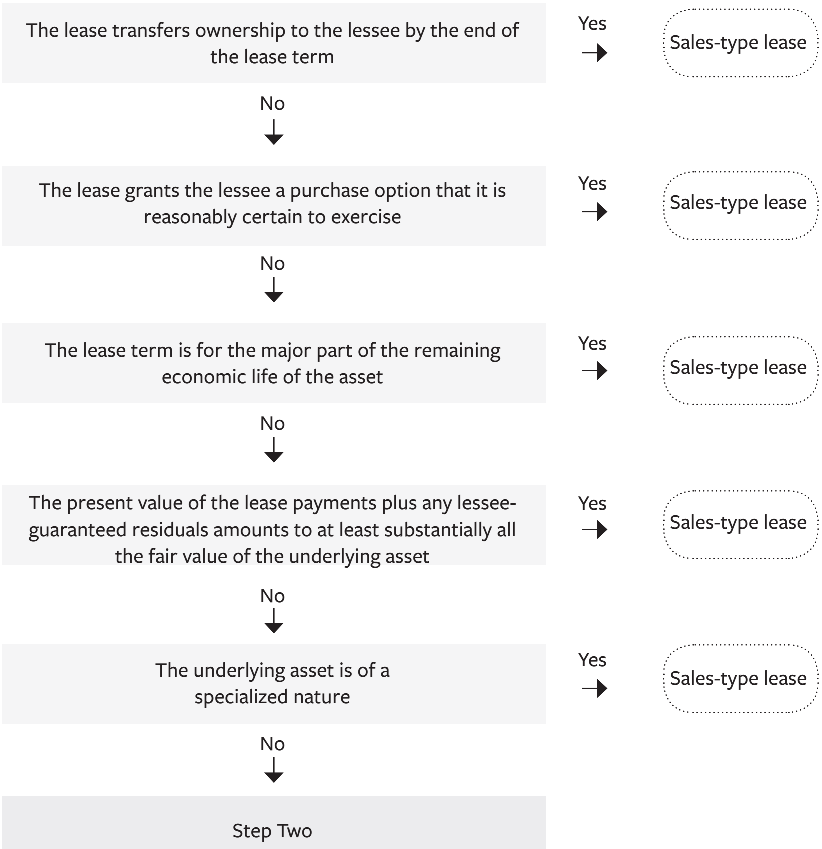
Using the prior example, if the lessee was confident that the fair value of the residual would not fall below 49,000, it would only include 1,000 in lease payments (50,000 stated amount – 49,000 expected value) when measuring its liability. If that expectation changes during the term of the lease, the lessee must reflect that change by revising the lease payments.

LESSOR

ASC 842 makes a distinction between two types of finance leases. In a sales-type lease, the contract transfers the risks and benefits of ownership from the lessor **only to the lessee**. In a direct financing lease, the contract transfers the risks and benefits of ownership from the lessor to the lessee and/or an **unrelated third party**. This distinction requires ASC 842 lessors to follow an expanded, two-step classification process.

Step One of the lessor classification process is illustrated in Figure Two. Note how ASC 842's present value test of Step One distinguishes between lease payments and residuals guaranteed by the lessee.

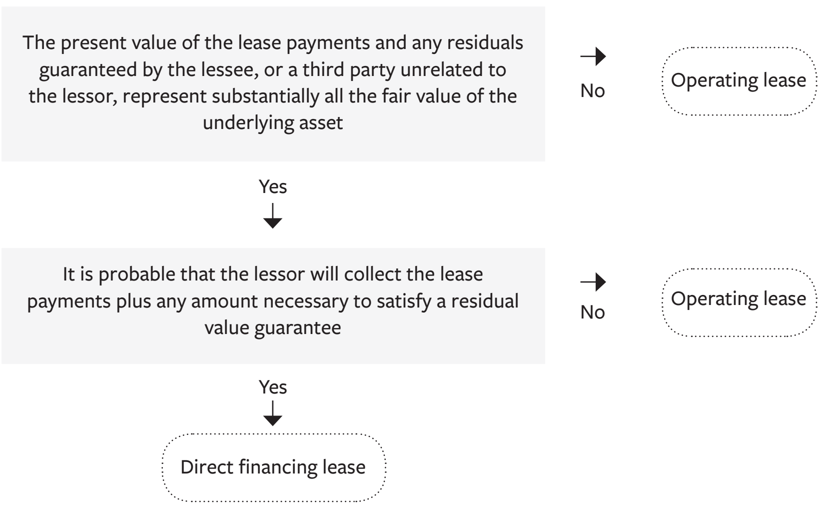
Figure Two / ***ASC 842 Lessor Lease Classification — Step One***



If none of the criteria in Step One are met, the lessor proceeds to Step Two, which measures the effect on the present value of adding any third-party residual guarantees into the present value calculation. Step Two is illustrated in Figure Three. Note how the present value test of Step Two includes third-party residual guarantees and adds a step related to collectability of the lease payments and the guaranteed residual.

The additional criteria regarding collectability of the lease payments and residual value guarantee were added to reflect the nature of a direct financing lease in which an unrelated third party guarantees the residual. In such circumstances, the asset risk is mitigated, so the nature of the transaction becomes more like a financing subject to credit risk. Consequently, ASC 842 requires that collectability of the payments and guaranteed residual amounts be probable.

Figure Three / ***Lessor Lease Classification — Step Two***



EXAMPLE

The prior DMC example, modified to reflect a vendor-guaranteed residual, is used to illustrate the process the lessor must follow when classifying a transaction under ASC 842.

EXAMPLE

DMC Finance is leasing equipment to Reidesign, Ltd., so it can run its projects more effectively. The transaction is an FMV lease that, under its terms, gives Reidesign the option at lease end to return the equipment, buy the equipment at fair value, or renew the lease at fair value. DMC is uncertain as to whether Reidesign will exercise either the purchase or the renewal option.

The following assumptions represent the specific parameters of the lease.

Date the asset is delivered:	April 1
Lease term:	48 months
Payment amount:	2,006.32, in advance
Unguaranteed residual	14,478
Vendor guaranteed residual	3,000
Equipment fair value	90,000 (which also is the cost)
Implicit rate:	10% (.8333 per month)
Lessor's initial direct costs:	1,500, consisting of a broker fee of 2,000 and a 500 closing fee collected from the lessee

Classifying the lease

DMC must apply the five, lease classification criteria of Part One to the transaction at lease commencement, plus the additional two criteria of Step Two, to determine whether the transaction is a sales-type, direct financing, or operating lease. In this example, there is a vendor-guaranteed residual, but all the other elements remain the same. Consequently, the only difference in the classification approach relates to the present value test.

Step One

The present value test in Step One is as follows. It is assumed that none of the other classification tests of this step are met.

» **The present value of the lease payments and any lessee residual value guarantees equal or exceed substantially all the fair value of the underlying asset** – the first step in this criterion is to establish the comparison base of 90% of the asset's fair market value

90,000	(fair value)
x 90%	
81,000	Comparison base

The present value of the lease payments only (there is no lessee-guaranteed residual) of 79,764.72, using an implicit rate of 10%, is less than 81,000, so this criterion is not met.

Step Two

Since none of the five, lease classification criteria of Step One were met, DMC must proceed to Step Two of the classification test. The present value test of Step Two includes the effect of any third-party residual guarantees.

» **The present value of the lease payments and any residual amounts guaranteed by the lessee, or a third party unrelated to the lessor, equal or exceed substantially all the fair value of the underlying asset** – the comparison base of 90% of the asset's fair market value remains the same at 81,000.

The present value of the lease payments and vendor-guaranteed residual of 81,779.01, using an implicit rate of 10%, is greater than 81,000, so this criterion is met. DMC also assesses that collection of the lease payment and the residual guarantee is probable.

The sales-type lease criteria of Step One and the direct financing criteria of Step Two are met, so DMC records the lease as a direct financing lease.

Separating Lease and Non-lease Components

Customers increasingly are moving away from asset ownership and asking providers to charge a single fee for multiple services that generally rely on equipment in some way. These evolving changes in how equipment is used and financed create issues related to properly accounting for the multiple components in transactions, some of which may be subject to other accounting models.

As discussed in Chapter Two, one of these issues is whether or not the contract contains a lease. Other issues include separating the lease component from the other elements (non-lease components and noncomponents) of the transaction and then classifying the lease as appropriate. This section examines the process of separating the lease component of a transaction from the other components.

CONTRACT ELEMENTS

Lessees and lessors must distinguish between the various elements of a contract and correctly account for them, including properly allocating the contract consideration. Making the distinction between the lease component and other elements in a transaction is critical, as the accounting for leases (recording assets and liabilities) may not be appropriate for other elements of a transaction.

In this regard, the elements of a transaction that must be separated and accounted for in a transaction are broken down into three categories:

» **Lease components** – only the contract elements that are integral to providing the lessee the right to use an asset are considered lease components. The specific portion of the payment in the arrangement to use the asset would be a lease component

» **Non-lease components** – only the non-lease elements of the transaction that transfer a good or service are considered non-lease components of a transaction. The portions of the contract payment related to providing maintenance, service or disposables would be considered non-lease components

» **Noncomponents** – payments for activities and costs that do not transfer anything to the lessee, and typically are incurred by the lessor whether the asset is being leased or not, are considered noncomponents of the transaction.

As an example, a fleet management lessor uses trucks to provide its service, maintains the trucks, makes drivers available, provides safety training and supplies uniforms for the drivers. In return, the customer pays a monthly fee and reimburses the lessor for the property taxes it pays related to the overall service.

The various elements of this service require different accounting treatment than that required for the lease component (capitalization), so the lease components, non-lease components and noncomponents of the transaction must be separately identified. The steps for identifying and measuring the components of a transaction, which align with the revenue recognition standards, are laid out in Figure Four and explained in more detail in the following subsections.

Figure Four | ***Separating the Transaction Components***

Identify the separate lease components

↓

Identify any non-lease components

↓

Measure the consideration in the contract

↓

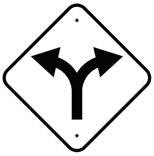
Allocate the consideration in the contract between the lease and non-lease components

If two or more arrangements are entered into at the same time, and with the same party, the contracts should be considered together for purposes of identifying and allocating the lease and non-lease components. This situation occurs when the contracts are negotiated as a package with the same commercial objective(s), the consideration to be paid in one contract depends on the price or performance of the other contract, and the rights to use the assets are a single lease component.

Practical expedients

Lessees may elect to not separate the lease and non-lease components of a transaction and, instead, capitalize the lease and associated non-lease components in the contract as a lease obligation. This election may be applied by class of underlying asset.

A Different Path



ASC 842 provides lessors with an election to combine the lease and non-lease components in a contract, by class of underlying asset. The lease component and the associated non-lease components must have the same timing and pattern of transfer, which means that the lease component, if accounted for separately, would be classified as an operating lease. If, however, the non-lease components are the predominant component in the contract, the lessor must account for the combined components in accordance with ASC 606.

IDENTIFY THE LEASE COMPONENTS

The first step in separating the transaction elements is to identify the separate lease components.[5] The lease component generally is the cost associated with the right to use the asset. The right to use an underlying asset is a separate lease component if:

» The lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee, and

[5] The right to use land should be accounted for as a separate lease component, unless the effect of doing so would be insignificant.

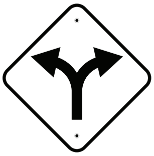
» The asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract

Readily available resources are goods or services that are sold or leased separately by the lessor or other suppliers, or resources that the lessee already has obtained. An asset is not highly dependent on, or highly interrelated with, other assets if the lessee could decide not to lease that asset without significantly affecting its rights to use the other underlying assets in the contract.

This would be the case in which a construction company leases forms trucks, a crane, concrete pumps and backhoes in order to provide its services. Whereas, these assets are deployed together when constructing a building, the contractor also could lease/use each piece of equipment independently to perform other services. Since none of the assets are highly dependent on, nor highly interrelated with, the other underlying assets in the contract, the contract contains multiple, separate lease components.

Noncomponents do represent lease payments. As such, they are included in the classification and measurement of the lease (although they generally would be variable). Noncomponents are not considered, however, when allocating the consideration in the contract between the lease and non-lease components, as they do not transfer a good or service. Instead, the lessee and the lessor allocate payments for noncomponents to the lease and non-lease components, as appropriate.

A Different Path



ASC 842 requires lessors to record noncomponents as gross revenues, with a corresponding offset to expenses, if paid by the lessor and subsequently reimbursed by the lessee. This requirement does not apply to those noncomponents, such as property taxes and insurance, paid directly by the lessee to the service provider or tax authority.

ASC 842 lessors also are not required to include sales, or similar, taxes in gross revenues if the tax is collected from a lessee on behalf of third parties (i.e., the lessor acts as an agent).

Property taxes and insurance costs of the lessor reimbursed by the lessee are examples of noncomponents, as would be commitment fees. Consider the lease of an ore crusher to a mining company. Under the terms of the lease, the lessee pays for the costs (rent) to use the ore crusher, including the property taxes and insurance. This contract has only one component – the lease payment.

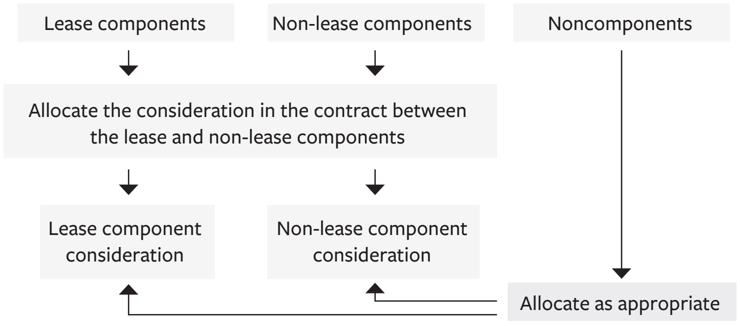
The property taxes and insurance are not components of the contract, but would be allocated to the appropriate component, as illustrated in Figure Five. The property taxes and insurance would be allocated to the lease component in this example.

IDENTIFY THE NON-LEASE COMPONENTS

Once the separate lease components are identified, the non-lease components, if any, must be identified so that the consideration in the contract can be allocated properly. Non-lease components transfer a good or service to the lessee and are not accounted for as leases, which is no surprise, given their eponymous description. The maintenance service provided by a lessor in a full-service lease is an example of a non-lease component, as would be training or disposables.

The treatment of non-lease components in lease accounting is based on the revenue recognition standards, although a non-lease component does not have to meet the definitions under IFRS 15 and ASC 606. Non-lease components also do not have to be in the form of a good or service. A tax indemnification clause in a lease agreement, for instance, would have to be evaluated as to whether it constituted a non-lease component.

Figure Five / ***Allocating Noncomponents***



MEASURE THE CONTRACT CONSIDERATION

The separate lease components and non-lease components must be identified by the lessor and the lessee, so that the contract consideration can be allocated to them. The noncomponents also must be identified so they can be allocated to the lease and non-lease components. The contract consideration is not to be allocated to the contract noncomponents. At this point in the process identified in Figure Four, the consideration in the contract must be measured.

Lessees

The contract consideration for lessees includes:

» The lease payments (as defined earlier and in Chapter Four)
» Any other fixed payments
» Any other variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date

The lessee does not include any variable payments that do not depend on an index or rate, whether they are related to the lease components or non-lease components. Any incentives paid or payable to the lessee that are related to a non-lease component also are not included in the contract consideration.

EXAMPLE

Byrds Bancorp is bundling a lease of front-end loaders to McGuinn Manufacturing with a maintenance agreement. Under the arrangement, McGuinn will pay 5,000 per month over the 48-month term. The 5,000 payment includes a fixed amount of 1,000 for core maintenance costs. McGuinn also must pay a variable fee based on the number of hours the loaders are run.

The total consideration in the contract to be allocated between the lease and non-lease components is 240,000 (48 x 5,000). McGuinn would not include the hours-based fee in the contract consideration as it is not based on a rate or index.

Lessors

The contract consideration for lessors includes all the contract consideration the lessee recognizes plus an estimate of any variable consideration related to the non-lease components. This guidance is consistent with IFRS 15 and ASC 606.[6]

The estimate of variable consideration should be included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the variability in the payments is resolved.

EXAMPLE

Byrds Bancorp is bundling a lease of front-end loaders to McGuinn Manufacturing with a maintenance agreement. Under the arrangement,

[6] The Boards did not require this approach for lessees, as it was considered to be too burdensome for any benefit gained.

McGuinn will pay 5,000 per month over the 48-month term. The 5,000 payment includes a fixed amount of 1,000 for core maintenance costs.

McGuinn must pay a variable fee based on the number of hours the loaders are run, a fee which Byrds reliably estimates to be an additional 1,200 per month. As part of the arrangement, Byrds will provide specialized hydraulic fluid for the front-end loaders. Based on Byrds' knowledge of its customer's operations and the equipment, it expects this amount to average 50 per month.

The total consideration in the contract to be allocated between the lease and non-lease components is 242,400 [(48 x 5,000) + (48 x 50)]. The variable maintenance is not included in the consideration as it is related to the lease component.

ALLOCATE THE CONTRACT CONSIDERATION

Lessors and lessees must allocate the contract consideration between the lease and non-lease components. Each component of the arrangement must be allocated a portion of the contract consideration (i.e., no component can be allocated a zero amount of the consideration).

Lessees

The lessee allocates the contract consideration proportionally between the lease and non-lease components based on the relative standalone price of each component. The standalone price is the amount a customer would pay if it purchased the component separately. The standalone prices in the allocation are based on observable standalone prices (observable inputs represent the top tier of information in this process).

A price is observable if it is the price at which either the lessor or other suppliers sell similar lease or non-lease components on a standalone basis. Lessees may have to use judgment and comparisons to similar transactions to determine standalone prices in some instances. Initial direct costs should be allocated to the separate lease components on the same basis as the lease payments.

If observable standalone prices are not readily available, the lessee estimates the standalone prices. This estimation is based on a robust analysis of other observable information. A residual estimation approach, in which a standalone price is determined by deducting the observable standalone prices from the total contract consideration, may be appropriate if the standalone price for a component is highly variable or uncertain.

Example

The following example illustrates how a lessee would allocate the contract consideration.

EXAMPLE

MC5, Ltd. Is a specialty subcontractor that provides footings, piling, and foundation services to multiple contractors. MC5 uses its own riggers and various pieces of equipment, including forms, trucks, a crane, concrete pumps, etc., to do so. MC5 has entered into a contract with The Brogues Financial Corporation for two, 385,000 BTU/h hydronic surface heaters.

In addition to use of the surface heaters, the arrangement provides for service (fixed charge, no additional fees for excess run time), technical training and telematics support. The contract terms require a monthly payment of 5,090 for 60 months, plus an estimated 2,000 per year for property taxes. MC5 has determined that the arrangement contains a lease.

MC5 must identify the separate elements of the contract and allocate the contract consideration to each element. This contract contains lease components, non-lease components and noncomponents.

The total consideration in the contract to be allocated between the lease and non-lease components is 305,400 (60 x 5,090). MC5 has obtained the following estimates of standalone prices from various lessors and suppliers. These observable, standalone prices were readily available.

- Similar leases – 3,800 per month
- Similar maintenance services – 1,400 per month
- Similar technical training – 5,100 total (5,100 ÷ 60 = 85 per month)
- Telematics support – MC5 ignored this non-lease component as it deemed the cost to be insignificant

Based on the observed standalone prices, MC5 allocates the total contract consideration according to Figure Six. The property taxes (a noncomponent), in addition to being variable, are not part of the contract consideration that is allocated to the lease and non-lease components. Instead, they would be allocated directly to the lease component (if non-variable).

Figure Six | ***Lessee Allocation of the Contract Consideration***

Component	Standalone price	Allocation
Lease	3,800	3,659.90[7]
Service	1,400	1,348.34
Training	85	81.86
Total	5,285	5,090.00

The consideration in this example was allocated to the lease components in toto, when, in reality, the arrangement contains two lease components. MC5 can benefit from the use of each surface heater on its own, as they are neither highly dependent

[7] (3,800 x [5,090 ÷ 5,285]).

on, nor highly interrelated with each other. Consideration, therefore, should have been allocated to each of these lease components.

The result of doing so in this example, of course, does not alter the allocation, as the two lease components are exactly the same. If the non-integrated assets are not the same, however, each lease component must be identified, and the contract consideration allocated to it based on observable standalone prices. In addition to complying with the guidance in the Standards, doing so also creates managerial reporting benefits.

MC5 would use the 3,659.80 combined lease component in this example to recognize the lease liability and ROU asset in its balance sheet, while the non-lease components would be recognized as expense on a linear basis over the life of the lease.

Assume that the arrangement in this example included an additional maintenance fee if MC5's usage of the ground heaters exceeded a predetermined number of hours. MC5 would not account for those variable payments as consideration in the contract in that case, as the variable payments depend on usage, not an index or a rate.

Lessors

The lessor allocates the contract consideration to the separate components in the arrangement based on the guidance in IFRS 15 and ASC 606, as applicable. This allocation generally will be a proportional allocation based on stand-alone selling prices, which is similar in concept to how lessees allocate the consideration. Lessors, however, also must consider the effect of discounts and variable payments on the allocation.

The stand-alone selling price for a lessor is the price at which it (not others) normally would sell the good or service, on a separate basis, to similar customers and in similar circumstances. As with lessees, the best evidence of a stand-alone selling price for a good or service is the observable price of that good or service. These standalone, observable prices are those at inception and are not revisited, other than in the case of modifications that are not accounted for as separate contracts.

If the stand-alone selling price of a component is not observable, the lessor estimates the standalone prices. This estimation is based on a robust analysis of other observable information that is reasonably available, such as market conditions and information about the customer or class of customer. A list price for a good or service may be (but should not be presumed to be) the stand-alone selling price of that good or service.

Acceptable methods of estimating the stand-alone selling price include:

» **Adjusted market assessment approach** – evaluate the market in which the lessor sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services

» **Expected cost plus a margin approach** – forecast the lessor's expected costs of providing a good or service and then add an appropriate margin to that cost

» **Residual approach** – but only if the lessor sells the same good or service to different customers and the selling price is uncertain because the selling price is highly variable or a price for that good or service has not yet been established and the good or service has not previously been sold on a stand-alone basis

If the sum of the stand-alone selling prices in the contract exceeds the promised consideration, there is a discount in the transaction. A discount is allocated proportionally to all components in the transaction unless there is observable evidence that the discount relates to only one or more, but not all, of the contract components. This guidance is consistent with that of IFRS 15 and ASC 606.

Allocation of variable consideration in the contract tracks the same concept as allocation of a discount. Variable consideration is allocated proportionally to all components in the transaction unless the terms of the variable payment relate specifically to one or more, but not all, specific components. The result of the allocation in this situation also must be consistent with the allocation objectives of the revenue recognition standards.

Variable payments, by their nature, are not recognized in revenue until they occur, which means they also cannot be allocated until they occur. Variable payments are allocated to the lease and non-lease components when recognized. This allocation is in the same proportion as the initial allocation of the contract consideration at inception, unless they relate to specific non-lease components.

Example

The following example illustrates how a lessor would allocate the contract consideration.

EXAMPLE

The Brogues Financial Corporation has entered into a contract with MC5, Ltd., a specialty subcontractor that provides foundation services to multiple contractors. The contract is for two, 385,000 BTU/h hydronic surface heaters.

In addition to use of the surface heaters, the arrangement provides for service, technical training and telematics support. The contract terms require a monthly payment of 4,790 for 60 months, plus a reimbursement of property taxes by MC5. These taxes are estimated to be 2,000 per year.

The maintenance portion of the contract consideration consists of a base amount of 900, plus an additional portion if MC5's usage of the ground heaters exceeds a predetermined number of hours. Based on its experience with customers similar to MC5, Brogues reliably estimates this additional charge to be 400 per month. Brogues has determined that the arrangement contains a lease.

Brogues must identify the separate elements of the contract and allocate the contract consideration to each element. This contract contains lease components, non-lease components and noncomponents. The total consideration in the contract to be allocated between the lease and non-lease components is 287,400 (60 x 4,790). Brogues has determined the prices it charges similar customers in similar circumstances, as follows.

- Normal lease price – 3,850 per month
- Normal base (noncomprehensive) maintenance services – 900 per month
- Technical training – 5,400 total (5,400 ÷ 60 = 90 per month)
- Normal telematics support price – 5 per month

As can be seen in Figure Seven, the contract consideration reflects a discount to MC5. Brogues arrived at the contract consideration of 4,790 based on a market-based pricing exercise. Consequently, the discount does not apply to any particular component of the transaction.

Based on its normal selling prices, Brogues allocates the total contract consideration according to Figure Seven. The property taxes (a noncomponent), in addition to being variable, are not part of the contract consideration that is allocated to the lease and non-lease components. Instead, they are allocated directly to the lease component when earned.

Figure Seven / ***Lessor Allocation of the Contract Consideration***

Component	Standalone price	Allocation
Lease	3,850	3,806.30[8]
Service	900	889.78
Training	90	88.98
Telematics	5	4.94
Total	4,845	4,790.00

[8] (3,850 x [4,790 ÷ 4,845])

Note that, in Figure Seven, Brogues did not allocate the 400 anticipated variable payment related to usage of the ground heaters beyond the predetermined amount. This is because those variable payments are not solely related to performance of the non-lease component (maintenance services).

The variable payments are, in fact, a function of MC5's use of the ground heaters and that use substantively affects whether Brogues will earn the maintenance amounts. Since the variable payments are related to the lease component, they are not included in the contract consideration for allocation purposes.

Also note that the two lease components were treated as one lease component, as in the prior lessee example. Since the surface heaters are neither highly dependent on, nor highly interrelated with each other, they would be treated as separate lease components, with the consideration allocated to each.

Brogues would use the 3,806.30 lease component to classify the lease, record it in its balance sheet and recognize income over the life of the lease. The non-lease components would be recognized in income on a linear basis over the life of the lease.

Reallocation of the consideration

Lessees and lessors must remeasure and reallocate the remaining consideration in the contract in certain circumstances. These include when the lease liability is remeasured (for the lessee only) or when a lease modification occurs, and the modification is not accounted for as a separate contract.

Conclusion

The definitions, terminology and process for identifying lease and non-lease components discussed in this chapter are critical to classifying, recognizing and measuring leases from both the lessor and lessee standpoint. How these elements specifically apply to lease transactions is presented in the following chapters that examine how lessees and lessors account for their leases under the Standards.