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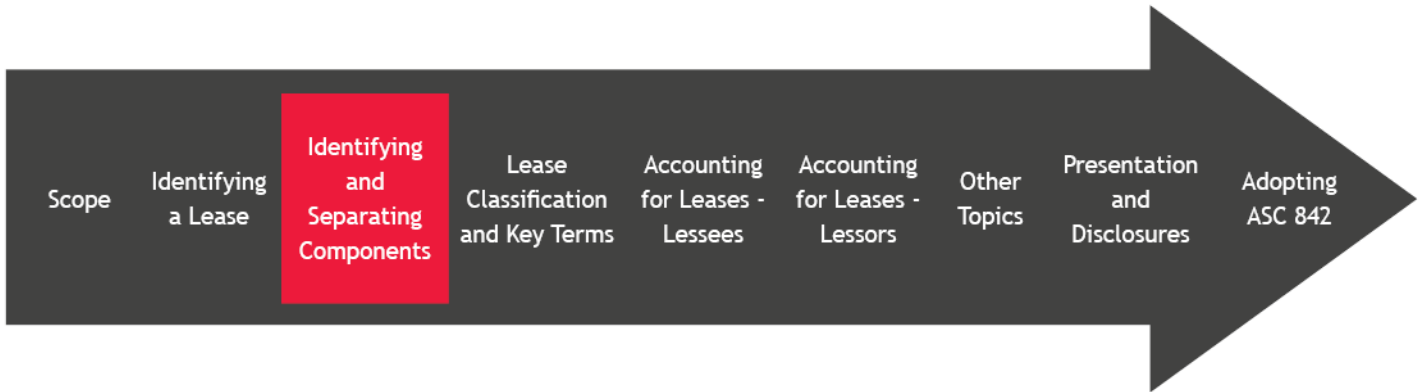
Accounting for Leases Under ASC 842

UPDATED SEPTEMBER 2021



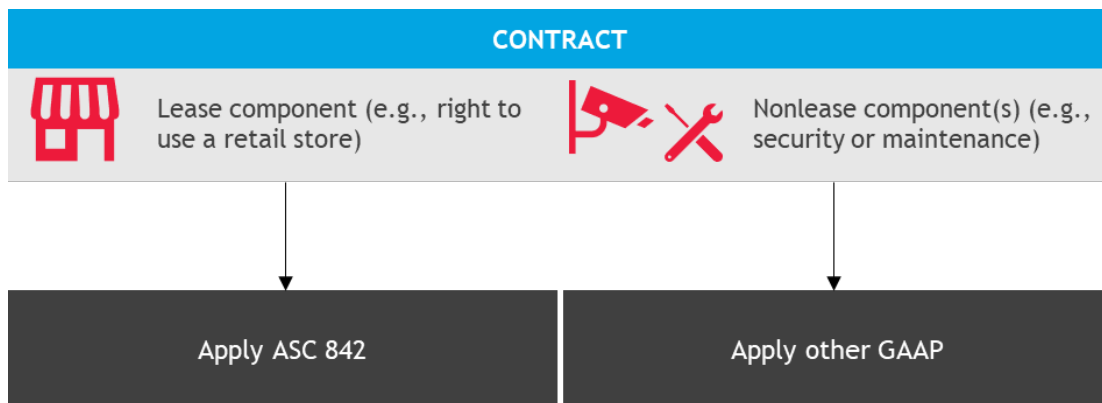


BDO Knows Identifying and Separating Components



OVERVIEW

In the previous article, we discussed how to [identify a lease](#). Once an entity concludes that a contract is or contains a lease, the next step is to identify the components of the contract. Those components are the units of account that determine which GAAP applies, and they only include those items or activities that transfer a good or service to the lessee. The definition of a lease is based on the right to use an identified asset and, therefore, the lease component typically represents the right to use that identified asset (such as the right to use a retail store). A contract may also include one or more nonlease components (such as maintenance or security services for that retail store). In that scenario, the lease component is accounted for under ASC 842, while the nonlease component(s) are generally accounted for under other GAAP.



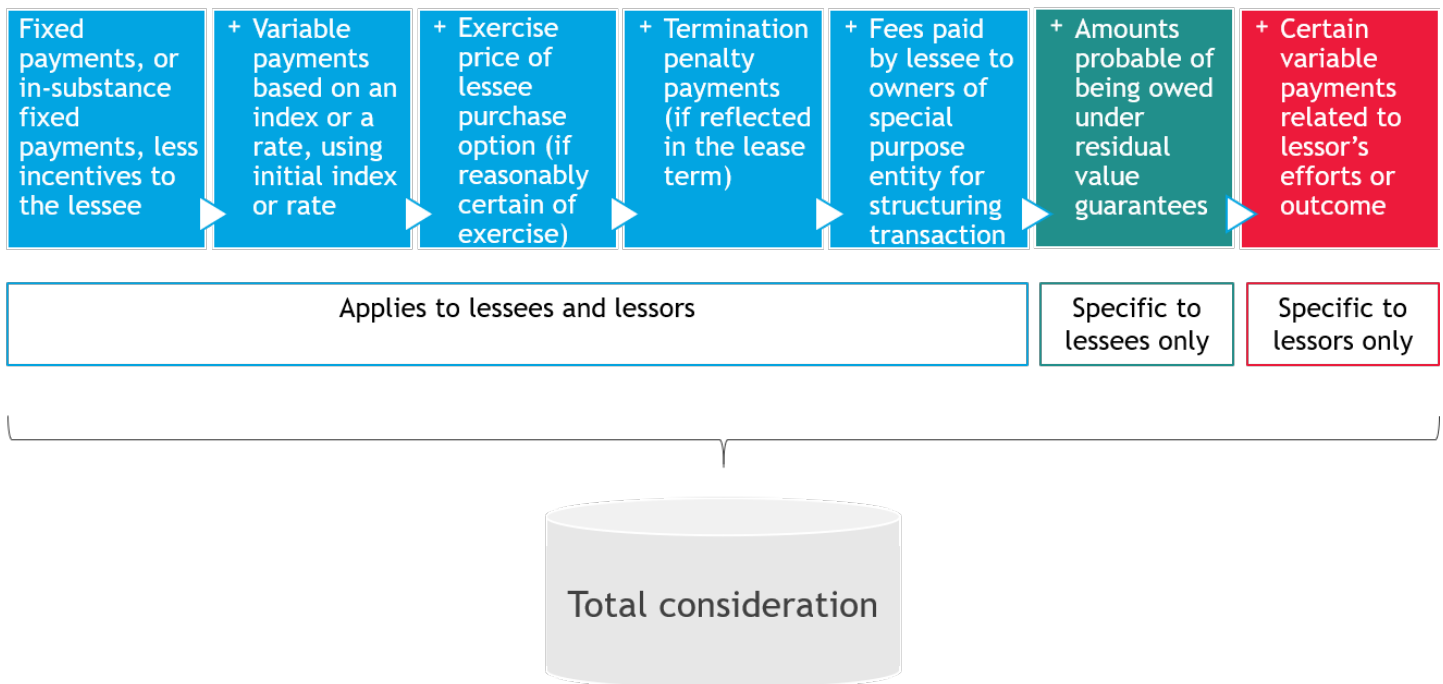
A contract may also include the lease of more than one asset. In those situations, the entity should evaluate how many lease components there are. Generally, the right to use each individual asset represents a separate lease component. For example, in a contract for the right to use two cars, each car represents a separate lease component, and the contract therefore includes two lease components. But sometimes leases of multiple assets are accounted for as one lease component depending on how dependent and interrelated, they are to each other. There are also specific considerations for leases of land.

Some items or activities do not transfer a good or service to the lessee and, therefore, are not considered components of the contract. Those include:

- ▶ Administrative tasks to set up the contract,
- ▶ Cost that a lessor would incur in its role as a lessor or as owner of the underlying asset (e.g., property taxes for which the lessor is the primary obligor and insurance that protects the lessor’s asset).

In addition to identifying the components of the contract, the entity must determine the consideration in the contract. It typically includes fixed payments (including in-substance fixed payments) less incentives to the lessee, and variable payments based on an index or a rate, measured using the index or rate at the commencement date. The consideration may also include other payments depending on the contract’s terms, such as the exercise price of a lessee purchase option if reasonably certain of exercise, or termination penalties if the lease term reflects exercise of a lessee termination option. A lessee does not include variable payments other than those based on an index or a rate, while lessors sometimes must include certain variable payments that relate specifically to nonlease components.

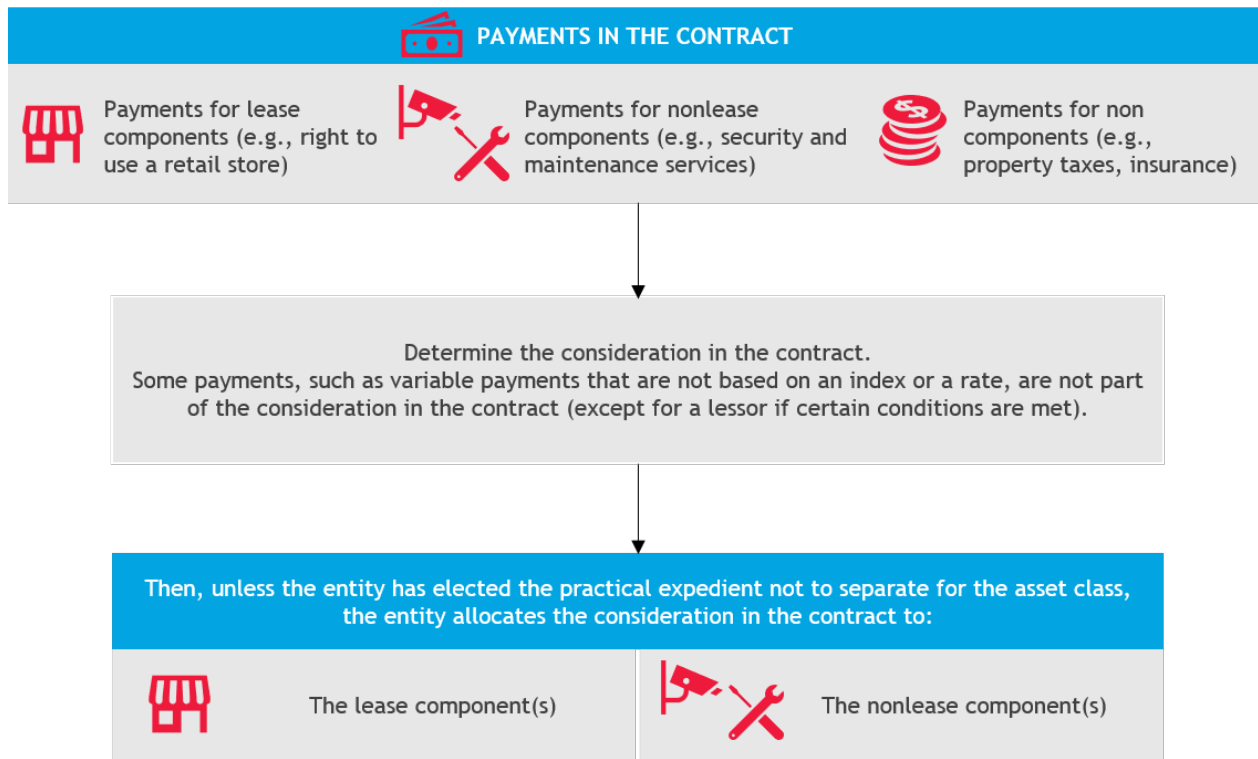
The following graph summarizes the consideration in the contract for lessees and lessors.



When a contract includes more than one lease component (for example, a contract with two lease components), or includes a lease component and at least a nonlease component, the entity typically must separate and allocate the consideration in the contract to those components, unless a practical expedient is elected (see below).

The allocation of the consideration is generally made on a relative standalone (selling) price basis, although lessors must apply the allocation guidance in ASC 606.

Also, items or activities that do not transfer a good or service to the lessee do not receive an allocation of the consideration in the contract because they are not considered components of the contract. This means that any payments in the contract for these items or activities, whether fixed or variable, will generally be allocated to the components of the contract as illustrated on the next page.



However, lessees and lessors can elect a practical expedient by asset class not to separate the nonlease component(s) from the associated lease component.

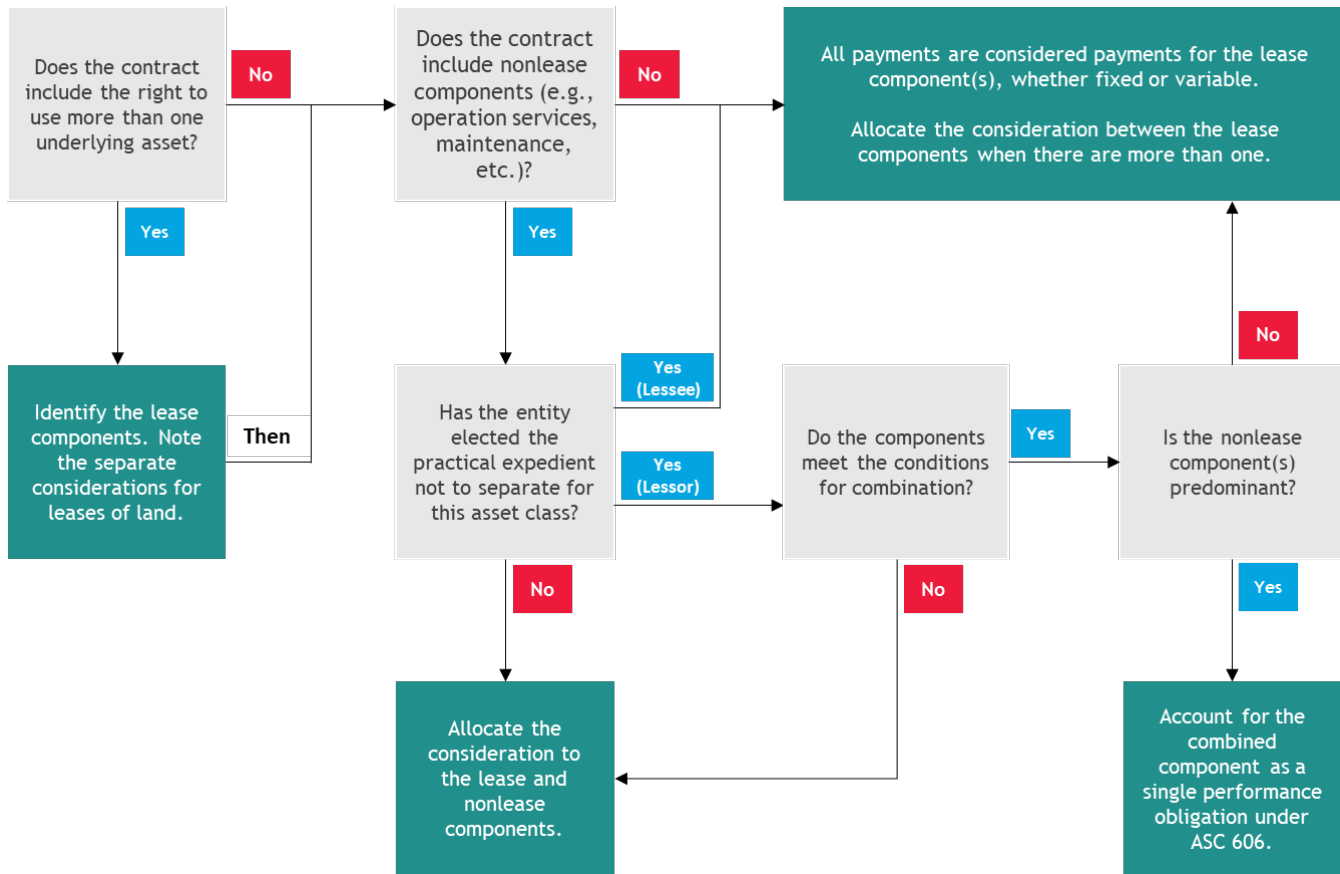
Lessees can generally apply the practical expedient without regard to conditions, and the combined component is accounted for under ASC 842.

Lessors may account for each separate lease component and the nonlease components associated with that lease component as a single lease component if the following three conditions are met:

- ▶ The nonlease component(s) otherwise would be accounted for under ASC 606,
- ▶ The timing and pattern of transfer of the lease component and nonlease component(s) associated with that lease component are the same, and
- ▶ The lease component, if accounted for separately, would be classified as an operating lease.

The accounting for the combined component then depends on which component of the contract is predominant which will dictate whether the lessor applies ASC 842 or ASC 606.

The following flowchart summarizes the key steps an entity should perform, which we will discuss in further details in this article.



Note that the above flowchart assumes that for a lessor, the nonlease component(s) in the contract will either meet the conditions to be combined with the lease component or won't. Sometimes, there may be nonlease components that meet the conditions, while some others don't. For example, a contract may include a lease of equipment, maintenance services related to that equipment, and a sale of consumables. In that situation, the lease component and maintenance services may meet the criteria to be combined, but the consumables will not because they are not provided over time. Therefore, if the lessor elected the practical expedient for the asset class, the lessor should allocate the consideration in the contract between the combined component (the lease component and maintenance) and the other nonlease component, which is the consumables. We will discuss this in further details in Separating Components - Lessors section below.

IDENTIFYING LEASE AND NONLEASE COMPONENTS

IDENTIFYING COMPONENTS OF THE CONTRACT

Components of a contract include only those items or activities that transfer a good or service to the lessee. Some other items or activities are not components.

Lease component examples	Nonlease component examples	Noncomponent examples
 Right to use real estate, such as a retail store.	 Repairs and maintenance, common area maintenance.	 Certain administrative tasks to initiate the contract (e.g., set up activities).
 Right to use computer equipment.	 Other goods or services provided to the lessee, such as security services, operating the asset (e.g., a vessel, a drilling rig), sale of consumables, etc.	 Reimbursement of lessor costs related to ownership of the leased asset (such as property taxes and insurance that protects the lessor’s asset).
 Right to use a vehicle, such as a truck.	 	

Lessees and lessors must identify the individual lease components and nonlease components of the contract, but do not have to separate the nonlease components from the associated lease component if a practical expedient to not separate is elected (see discussion below).

LEASE COMPONENT SEPARATION GUIDANCE

ASC 842 provides guidance in paragraph 842-10-15-28 on identifying separate lease components:



- ▶ In assessing the first condition, 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 (from the lessor or from other transactions or events). An entity may consider the following questions in determining whether this condition is met:
 - Is the asset readily sold or leased separately by the lessor or other suppliers?
 - Could the lessee readily lease or purchase an alternative asset to use with the other leased asset?

- ▶ In evaluating the second condition, a lessee's right to use an underlying asset is highly dependent on or highly interrelated with the right to use another underlying asset if each right of use significantly affects the other. An entity may consider the following questions in determining whether this condition is met:
 - Can the lessor fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations?
 - Would there be significant costs and time for the lessor to be able to fulfill its obligation on each leased asset?
 - Is the lessee's ability to derive benefits from the lease of each asset significantly affected by its decision to lease or not lease the other asset(s) from the lessor?

Lease Component Separation Guidance Similar to Guidance in ASC 606

The guidance in paragraph 842-10-15-28 on determining whether one or more lease components should be accounted for separately is similar to the guidance in paragraphs 606-10-25-19 through 25-21 on determining whether a good or service promised in a revenue contract is distinct, and therefore represents a separate performance obligation. This linkage was intentional as ASC 842 incorporates concepts from ASC 606, and therefore paragraph 842-10-15-28 should be applied in a manner similar to application of the guidance in ASC 606.

When applying paragraph 842-10-15-28, generally the right to use an underlying asset represents a separate lease component. For example, in a contract for the right to use two cars, each car represents a separate lease component, and the contract therefore includes two lease components. Also, while there are several potential underlying components that comprise each car, including the engine, seats, etc., the integral parts of the car do not meet the criteria for treatment as separate lease components. That is, the car is the lease component.

But in some cases, the right to use multiple underlying assets will represent a single lease component. Example 13 in ASC 842-10-55 illustrates a contract for the lease of a gas-fired turbine plant that consists of the turbine housed within a building together with the land on which the building sits. In that example, the rights to use the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which the lessee contracted (i.e, the right to use a gas-fired turbine plant that can produce electricity for distribution to the lessee's customers). Accordingly, they represent a single lease component (absent additional considerations for land - see below). However, the fact that a lessee will use multiple underlying assets for one purpose is not sufficient to conclude that the rights of use are highly interrelated or interdependent of each other. The FASB illustrated this in Example 11 of ASC 842-10-55. We also illustrate it in the following examples.

Example 1 - Lease of Helicopter and Jet

FACTS

- ▶ Lessee enters into a lease of a helicopter and a private jet from Lessor for two years for its key executives in the company for a specific project requiring significant travel.
- ▶ Lessor agrees to maintain the helicopter and the jet throughout the contract term.

ANALYSIS

- ▶ Lessee can benefit from each of the two assets on its own or together with other readily available resources. For example, Lessee could readily lease or purchase an alternative helicopter or jet to use with the other asset.
- ▶ Although Lessee is leasing the helicopter and jet for one purpose (key executives' travel related to a specific project), the helicopter and jet are not highly dependent nor highly interrelated with each other. The two assets are not, in effect, inputs to a combined item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligation, and Lessee's ability to derive benefits from the lease of each asset is not significantly affected by its decision to lease or not lease the other equipment from Lessor.
- ▶ The maintenance services represent nonlease components because they provide Lessee with goods or services separate from the lease of the jet and helicopter. Also, Lessor determines under ASC 606 that its maintenance services for each piece of leased equipment are distinct and therefore are separate performance obligations.

CONCLUSION

There are two separate lease components and two separate nonlease components, unless the entity elects the practical expedient not to separate for this asset class, in which case:

- ▶ For Lessee, the contract has two separate lease components under ASC 842 (see Separating Components - Lessee section for additional details),
- ▶ For Lessor, the contract has either two separate lease components under ASC 842 or two separate performance obligations under ASC 606 depending on predominance (see Separating Components - Lessor section for additional details).

Example 2 - Lease of Air Purification System

FACTS

- ▶ Clean Air Co. provides air purification systems, primarily to hospitals and other healthcare facilities, under leasing arrangements.
- ▶ Each system consists of multiple air filters and related equipment installed throughout the lessee's facility, in an amount and at locations determined based on the size and design of the facility.
- ▶ Lessee enters into a contract with Clean Air Co. for an air purification system that can filter the air at Lessee's healthcare facility and for maintenance of the system.
- ▶ Assume the contract contains a lease.

ANALYSIS

- ▶ Because of airflow throughout Lessee's facility, any individual air filter is ineffective on its own. Achieving air purification requires the full complement of air filters and related equipment provided in the arrangement.
- ▶ Therefore, the use of each air filter and related equipment used for the air purification system is highly dependent on the use of the other air filters and equipment. Each is an input to the customized combined item for which Lessee has contracted (that is, the right to use an air purification system that can filter the air at Lessee's healthcare facility).
- ▶ The maintenance services represent a nonlease component because they provide Lessee with goods or services separate from the lease. Also, Clean Air Co. determines under ASC 606 that its maintenance services represent a single performance obligation.

CONCLUSION

The contract contains one lease component (the right to use the air purification system) and one nonlease component (maintenance of the system), unless the entity elects the practical expedient not to separate for this asset class, in which case:

- ▶ For Lessee, the contract has one lease component under ASC 842 (see Separating Components - Lessee section for additional details).
- ▶ For Lessor, the contract has either one lease component under ASC 842 or one performance obligation under ASC 606 depending on predominance (see Separating Components - Lessor section for additional details).

Example 3 - Lease of Light Fixtures

FACTS

- ▶ Lighting Co. provides energy-efficient light fixtures, primarily in industrial settings, under leasing arrangements. Payments under the leasing arrangements are based on calculated cost savings to lessees.
- ▶ Each arrangement consists of multiple light fixtures installed throughout the lessee's facility, in an amount and at locations determined based on the size and design of the facility.
- ▶ Lessee enters into a contract with Lighting Co. for energy-efficient light fixtures.
- ▶ Assume the contract meets the definition of a lease.

ANALYSIS

- ▶ Lessee can benefit from each of the light fixtures on its own or together with other readily available resources. For example, Lessee could readily lease or purchase alternative light fixtures.
- ▶ The purpose of the light fixtures is to provide a lower cost alternative to traditional lighting solutions. However, each light fixture provides a similar estimated cost saving and would provide the same level of cost savings regardless of whether each light fixture was installed on its own, or as part of a larger installation. Therefore, the right to use each light fixture is neither highly dependent on nor highly interrelated with the use of the other light fixtures.

CONCLUSION

- ▶ The contract contains multiple lease components; that is, each light fixture is a separate lease component.
- ▶ Lessee and Lighting Co cannot apply the practical expedient not to separate to this contract because there are no nonlease components in the contract. However, the entity may consider applying a portfolio approach (see Portfolio Approach section).

SPECIFIC CONSIDERATIONS FOR LAND

Irrespective of the guidance discussed above on separating lease components, ASC 842 requires a lease of land to be accounted for as a separate lease component unless the accounting effects of such separation would be insignificant. Paragraph 842-10-15-29 discusses two examples in which the accounting effect is insignificant:

- ▶ Separating the land component would not affect lease classification of any lease components,
- ▶ The amount recognized for the land lease component would be insignificant.

The Board noted in paragraph BC147 of ASU 2016-02 that “land, by virtue of its indefinite economic life and nondepreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met.”

Identifying Leases of Land

Determining whether a contract includes a lease of land will depend on the facts and circumstances. In some cases, the analysis will be straightforward. For example, a contract for a lessee to lease an entire office building will include a lease of land on which the building sits, regardless of whether such lease of land is explicitly stated in the contract, because the lessee is leasing the entire building and therefore also exclusively benefits from the use of the land. In other cases, further analysis may be required. For example, in a contract for a lessee to lease retail space in a shopping mall, the analysis may depend on whether the lessee is the anchor tenant (and whether that anchor tenant occupies substantially all the shopping mall space), or another tenant that leases a smaller space (e.g., a lessee that leases a retail space on the second floor).

If it is determined that the contract includes a lease of land, the entity must account for the lease of land separately from the lease of the other assets unless doing so would be immaterial (e.g., lease classification would not change for either components, or the lease of land is immaterial).

Example 4 - Lease of Land and Building

FACTS

- ▶ Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The contract requires Lessee to pay Lessor for real estate taxes and insurance. Lessor is the primary obligor for the real estate taxes (regardless of whether Lessor leases the building and who the lessee is). Lessor is also the named insured on the insurance, which protects Lessor's investment in the building.
- ▶ The lease requires Lessor to perform landscaping services for Lessee.

ANALYSIS

- ▶ Regardless of whether the contract explicitly provides for the lease of land, the contract includes a lease of land because Lessee has exclusive use of the commercial office building, and therefore also exclusively benefits from use of the land on which the building sits.
- ▶ The lease of land and building are highly dependent on or highly interrelated with each other because each right of use significantly affects the other. However, because the contract contains a lease of land, Lessee and Lessor must consider the guidance in paragraph 842-10-15-29. Lessor and Lessee each conclude that the effect of accounting for the land lease component separately would be insignificant. In this contract, Lessee's right to use the land and building is coterminous and separating the two components would not change lease classification of either the land or building lease component.
- ▶ The real estate taxes and insurance on the building are not considered components of the contract because they are considered reimbursements of Lessor's costs for the land and building. See Separating Components - Lessee section and Separating Components - Lessor section for additional considerations on taxes and insurance.
- ▶ Finally, the landscaping services is a nonlease component because it transfers a good or service to Lessee separate from the lease of land and building. Lessor also determines under ASC 606 that the landscaping nonlease component represents a single performance obligation.

CONCLUSION

- ▶ The contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services), unless the entity elects the practical expedient not to separate for this asset class.
- ▶ See Separating Components - Lessee section for additional guidance on accounting for the components and Example 4A for a continuation of this Example for Lessee.
- ▶ See Separating Components - Lessor section for additional guidance on accounting for the components and Example 4B for a continuation of this Example for Lessor.

Example 5 - Lease of Office Space

FACTS

- ▶ Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ Lessee has exclusive use of the floor.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to reimburse Lessor for its pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges. The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.

ANALYSIS

- ▶ The contract does not include a lease of land because Lessee does not occupy substantially all of the building (i.e., the land on which the building sits is shared by all of the tenants in the building).
- ▶ The real estate taxes and insurance Lessee will pay to Lessor are not considered components of the contract because they are considered reimbursements of Lessor's costs for the building. See Separating Components - Lessee section and Separating Components - Lessor section for additional considerations on taxes and insurance.
- ▶ The common area maintenance service is a nonlease component because it transfers a good or service to Lessee separate from the lease of the floor. Lessor also determines under ASC 606 that the common area maintenance represents a single performance obligation.

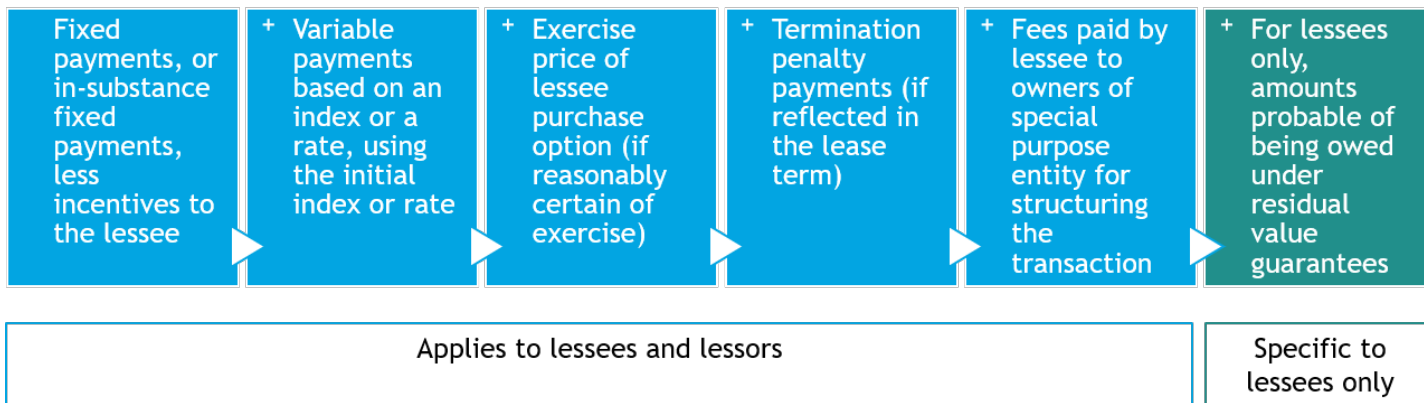
CONCLUSION

- ▶ The contract includes two components: one lease component and one nonlease component (common area maintenance services), unless the entity elects the practical expedient not to separate.
- ▶ See Separating Components - Lessee section for additional guidance on accounting for the components and Example 5A for a continuation of this Example for Lessee.
- ▶ See Separating Components - Lessor section for additional guidance on accounting for the components and Examples 5B and 5C for a continuation of this Example for Lessor.

SEPARATING COMPONENTS - LESSEES

DETERMINING THE CONSIDERATION IN THE CONTRACT

The consideration in the contract for a lessee is determined by applying paragraphs 842-10-15-35 and 842-10-30-5 and includes the following payments that will be made during the lease term:



For a lessee, the sum of the above payments represents the total consideration in the contract, which the lessee allocates to the separate lease and nonlease components of the contract, unless the lessee elects the practical expedient to not separate for this asset class (see discussion below).

Variable payments that depend on an index or a rate are initially measured using the index or rate at the commencement date. Subsequent changes to the index or rate during the lease term are accounted for as variable payments, unless the lessee is required to remeasure the lease for other reasons (see [Accounting for Leases - Lessees](#) for details).

Variable payments that do not depend on an index or a rate are not included in the determination of the total consideration in the contract. This includes variable payments based on the performance of the asset, such as payments based on a percentage of sales of the lessee, or reimbursement of actual costs incurred by the lessor (such as property taxes and insurance).

The next article in this series on [Lease Classification and Key Terms](#) discusses further details in-substance fixed payments, lease incentives, purchase options and termination options.

PROPERTY TAXES AND INSURANCE CONSIDERATIONS

A lessee's requirement to pay costs that the lessor may incur in its role as a lessor or as owner of the underlying asset do not transfer a good or service to the lessee separate from the lease. Example 12, Case A of ASC 842-10-55 provides an example of a real estate lease and explains that:

- ▶ The property taxes on the building would be owed by the lessor regardless of whether it leased the building and who the lessee is; and
- ▶ For the insurance, the lessor is the named insured on the building insurance policy and therefore the insurance protects the lessor's investment in the building.

Accordingly, the lessee paying those costs solely represents a reimbursement of the lessor's costs. The fact that the lessee pays a third-party, including the taxing authority, rather than reimbursing the lessor does not change this conclusion. Also, the classification of a lease (e.g., as operating versus finance lease for the lessee) does not affect the analysis of whether costs are considered lessor costs or lessee costs.

The accounting by a lessee for reimbursement of lessor costs depends on whether the payments are fixed or variable.

Payments are fixed	Payments are variable
Payments are included in the consideration in the contract, which is allocated to the lease and nonlease components in the contract on a relative standalone price basis, unless the lessee elects the practical expedient not to separate for the asset class. Those payment amounts (or a portion of those if there are nonlease components) will affect the measurement of the lease on balance sheet.	Payments do not represent variable payments based on an index or a rate and, therefore, are not included in the consideration in the contract. Once the variable payments are incurred, they will be allocated between the lease and nonlease components using the same allocation as at contract's inception, or most recent reallocation.
Example: Lessee is required to pay lessor a fixed amount per year for insurance coverage on the leased asset.	Example: Lessee is required to reimburse lessor for actual property taxes due on the asset under lease. Property taxes do not represent an index or a rate, and therefore are considered variable payments.

In some cases, there may be additional complexity in differentiating between lessee costs and lessor costs, particularly for insurance contracts for which there may be elements benefitting the lessor (e.g., protecting the leased asset) and others benefitting the lessee (e.g., protecting the lessee's owned assets or other contingencies). In those situations, additional analysis may be required to determine the portion of the payments that represent lessor costs (i.e., portion of the premium that protects the lessor's asset). Amounts that are considered lessee costs (i.e., portion of the premium protecting the lessee's assets) do not affect the accounting for the lease.

SALES TAXES AND SIMILAR TAXES

When an entity enters into a lease, taxes may be assessed on the contract by a governmental authority. Those taxes may be both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. Unlike lessors (see Separating Components - Lessor section), lessees do not have a practical expedient to not assess such taxes. Accordingly, a lessee is required to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased (i.e., the tax is a lessor cost) or whether those taxes are collected by the lessor on behalf of third parties (i.e., the tax is a lessee cost).

- ▶ If a lessor cost, the tax is accounted for either as part of the consideration in the contract (if the payments are fixed) or as variable payments that do not depend on an index or a rate.
- ▶ If a lessee cost, the tax typically does not impact lease accounting for the contract.

Like property taxes and insurance discussed above, the fact that the lessee pays a third-party directly rather than reimbursing the lessor for the tax does not impact this conclusion.

PRACTICAL EXPEDIENT NOT TO SEPARATE

A lessee may elect as an accounting policy election by asset class, to not separate nonlease components from lease components and instead, to account for each separate lease component and nonlease components associated with that lease component as a single lease component.

The FASB provided this practical expedient to reduce cost and complexity in applying ASC 842. However, the election of the practical expedient results in a larger right-of-use asset and lease liability on balance sheet, and it may also change classification from an operating to a finance lease (See article 4 on [Lease Classification and Key Terms](#)). Accordingly, companies will need to consider the pros (e.g., simplicity) and cons (e.g., impact on accounting for the lease, including balance sheet) of electing the practical expedient for their asset classes.

Nonlease Components “*associated with*” the Lease Component

ASC 842 does not define or provide guidance for determining whether a nonlease component is “associated with” the lease component. A literal read of the requirements for the practical expedient may suggest that all nonlease components, whether provided at a point in time or over time, that are associated with the lease component should be combined with that lease component when the lessee elects the practical expedient. However, we note that ASC 842 illustrates in Example 11 of ASC 842-10-55 the application of the practical expedient to a contract in which the nonlease component is maintenance *services* on construction vehicles. Paragraph BC 149 of ASU 2016-02 also notes that “[t]he Board also decided that lessees should account for lease and nonlease (*typically, service*) components separately (unless they elect the practical expedient) [*Emphasis added*].” Accordingly, we believe the practical expedient to not separate was primarily intended for services and other nonlease components transferred over time and that relate to the lease component (e.g., maintenance of a leased equipment, common area maintenance for a lease of office space). For nonlease components provided at a point in time such as inventory purchases, we believe a lessee will frequently conclude that the component is not associated with the lease component because the lessee usually will be able to redirect the inventory and use it with a different asset, or to resell it in the market.

ALLOCATION OF CONSIDERATION TO LEASE AND NONLEASE COMPONENTS

If a lessee does not elect the practical expedient not to separate for an asset class, once the consideration in the contract is determined and the components are identified, a lessee allocates the consideration to the lease and nonlease components on a relative standalone price basis, based on the observable standalone price of each component. A price is observable if it is the price at which either the lessor or similar suppliers sell similar lease or nonlease components on a standalone basis.

If observable standalone prices are not readily available, a lessee must estimate standalone prices maximizing the use of observable information. A residual approach may be acceptable if the standalone price for a component is highly variable or uncertain.

Paragraph BC156 in ASU 2016-02 states in part that “the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP.”

A lessee also allocates initial direct costs to the separate lease components on the same basis as the lease payments.

Example 6 - Lease of a Car

FACTS

- ▶ Lessee leases a car for its salesperson from Dealership for three years.
- ▶ Lessee has the right to drive the car for up to 15,000 miles per calendar year and to bring the car into the maintenance department of Dealership once per quarter for regularly scheduled maintenance as defined in the lease agreement.
- ▶ The contract provides for a fixed payment of \$415 per month.
- ▶ Lessee is required to maintain full coverage insurance on the car to protect Dealership’s asset. Lessee must contract directly with an insurance agency of its choice.
- ▶ Lessee is required to pay for any maintenance services required beyond regularly scheduled maintenance defined in the contract.
- ▶ At the end of the lease term, Lessee is required to make additional fixed payments on a per mile basis for any mileage greater than 45,000 miles.
- ▶ Assume there are no lease incentives or initial direct costs.

WHAT ARE THE COMPONENTS?

- ▶ The contract contains two components: a lease component (lease of the car) and a nonlease component (maintenance services). The insurance coverage is not a component. It does not transfer a good or service separate from the lease of the car (it represents a lessor cost of owning the asset).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The contract includes a fixed monthly payment of \$415, payments for insurance (paid by Lessee directly to the insurance company of its choice), payments for excess mileage at the end of the lease term, and payments for extra maintenance.
- ▶ Only the fixed monthly payment of \$415 is included in the consideration in the contract. The other payments are variable payments that do not depend on an index or a rate.
- ▶ The consideration in the contract is \$14,940 ($\415×36 months).

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.

- ▶ In that situation, the contract includes only one component (i.e., the lease component).
- ▶ The consideration in the contract of \$14,940 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ All variable payments (for insurance, excess mileage and extra maintenance, if any) are considered variable lease payments, which will be recognized in the period in which the obligation for those payments is incurred. Lessee will also consider the guidance in paragraph 842-20-55-1 for variable payments based on the attainment of 45,000 miles.

SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessee allocates the consideration in the contract to the lease and maintenance components on a relative standalone price basis. Lessee identifies observable standalone prices for the vehicle lease and maintenance services. Lessee determines that it could enter into a maintenance agreement with an unrelated service center for \$30 per month, and Dealership commonly leases the same car on a standalone basis for \$400 per month. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

	<u>Standalone Price</u>	<u>Relative Standalone Price</u>
Car lease	\$14,400	\$13,898 (93.02%)
Maintenance	1,080	1,042 (6.98%)
	<u>\$15,480</u>	<u>\$14,940</u>

- ▶ The amount of the consideration allocated to the lease component (\$13,898) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ The amount of consideration for the maintenance component (\$1,042) is accounted for under other GAAP.
- ▶ All variable payments for insurance, excess mileage and extra maintenance will be allocated when incurred using the same allocation basis as for the consideration in the contract (i.e., on a 93.02%/6.98% basis).

Example 4A - Lease of Land and Building (Continued) - Lessee Accounting**FACTS**

- ▶ Let's continue with Example 4 in which Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The lease requires Lessor to perform landscaping services for Lessee.
- ▶ Lessee pays a fixed monthly payment of \$12,000 per month in arrears which includes rent, landscaping services, and reimbursement of Lessor's costs.
- ▶ Assume there are no lease incentives or initial direct costs.

WHAT ARE THE COMPONENTS?

- ▶ As previously evaluated, the contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The consideration in the contract is $\$12,000 \times 12 \text{ months} \times 5 \text{ years} = \$720,000$

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.

- ▶ In that situation, the contract includes a single lease component.
- ▶ The consideration in the contract of \$720,000 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).

SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessee allocates the consideration in the contract to the lease component and landscaping services component on a relative standalone price basis. Lessee determines the standalone prices for the lease component and nonlease component are \$680,000 and \$50,000, respectively. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

	<u>Standalone Price</u>	<u>Relative Standalone Price</u>
Lease component	\$680,000	\$670,685 (93.15%)
Maintenance component	50,000	49,315 (6.85%)
	<u>\$730,000</u>	<u>\$720,000</u>

- ▶ The amount of the consideration in the contract allocated to the lease component (\$670,685) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.). The amount of consideration for the maintenance component (\$49,315) is accounted for under other GAAP.

Example 5A - Lease of Office Space (Continued) - Lessee Accounting**FACTS**

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.

WHAT ARE THE COMPONENTS?

- ▶ As previously evaluated, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The consideration in the contract is $\$50,000 \times 12 \text{ months} \times 5 \text{ years} = \$3,000,000$.
- ▶ The other payments Lessee will make to Lessor for its prorata share of real estate taxes, insurance and CAM are variable payments that do not depend on an index or a rate. Therefore, they are not included in the consideration in the contract.

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?**SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.**

- ▶ In that situation, the contract includes only one component (i.e., the lease component).
- ▶ The consideration in the contract of \$3,000,000 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ Lessee's payments for its prorata share of property taxes, insurance and CAM are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability. Those variable lease payments are recognized in profit or loss when incurred.

SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessee allocates the consideration in the contract to the lease and CAM components on a relative standalone price basis. Lessee determines the standalone prices for the lease component and CAM component are \$3,270,000 and \$270,000, respectively. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

	Standalone Price	Relative Standalone Price
Lease component	\$3,270,000	\$2,771,186 (92.37%)
CAM component ⁽¹⁾	270,000	228,814 (7.63%)
	<u>\$3,540,000</u>	<u>\$3,000,000</u>

⁽¹⁾ Includes an appropriate profit margin

- ▶ The amount of the consideration allocated to the lease component (\$2,771,186) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ The amount of consideration allocated to CAM services (\$228,814) is accounted for under other GAAP.
- ▶ All variable payments for Lessee's prorata share of real estate taxes, insurance, and CAM are allocated using the same allocation basis as for the consideration in the contract (i.e., on a 92.37%/7.63% basis).

In the prior example, it is important to note that if the practical expedient not to separate is not elected, the variable payments must be allocated between the lease and nonlease components despite the fact that the lease clearly provides for specific charges related to the nonlease services, i.e. CAM. This is because a lessee is not allowed to allocate variable consideration solely to the nonlease component, as lessors are allowed to.

APPLYING THE RESIDUAL APPROACH

In accordance with paragraph 842-10-15-33, if a lessee has elected to separate lease and non-lease components, then it must allocate the consideration in the contract between the lease component(s) and the non-lease component(s) on a relative standalone price basis. The guidance further states that "if observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information." The guidance also indicates that "a residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain."

Paragraph BC156 of ASU 2016-02 states in part that "the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP." Lessors apply the allocation requirements in ASC 606, including paragraph 606-10-32-34, which provides the guidance on the suitable methods for estimating the standalone selling prices (including a residual approach). In accordance with paragraph 606-10-32-34(c), under the residual approach an "entity may estimate the standalone selling price by reference to the total transaction price less the sum of the *observable* standalone selling prices of other goods or services promised in the contract. [*Emphasis added*]" However, the following criteria must also be met in order to use the residual approach:

- ▶ The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence); or
- ▶ The entity has not yet established a price for that good or service and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

As suggested by the guidance above, a lessee must have observable standalone prices for at least some of the components in the contract to apply the residual approach. In other words, if the lessee does not have observable standalone prices for any of the components, it must estimate the standalone price for all components. That is, the lessee cannot use the residual approach.

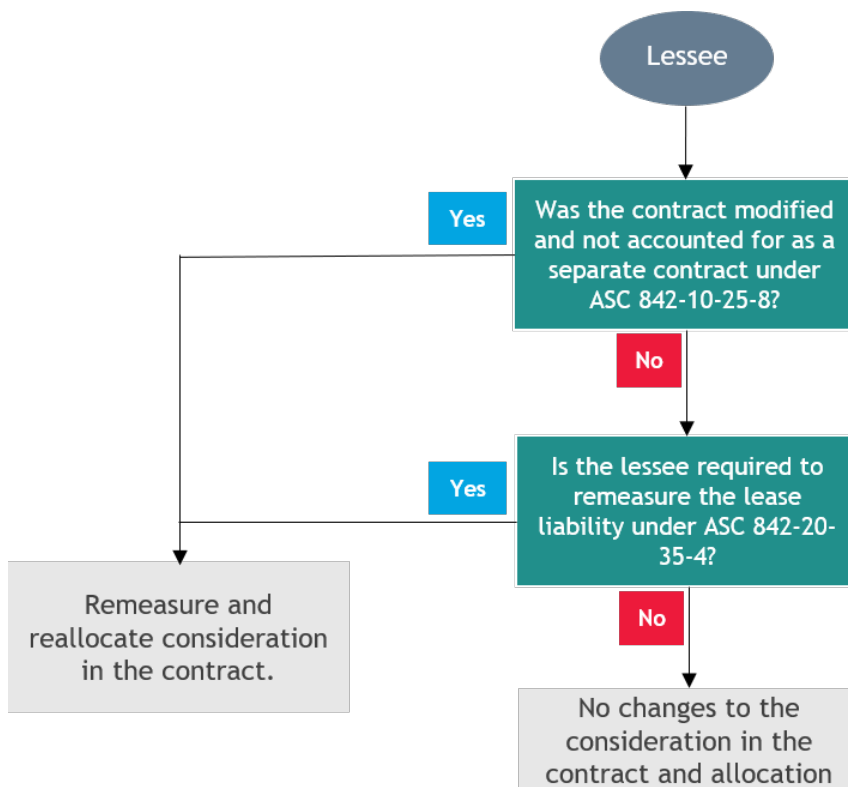
In addition, in order for a lessee to meet the additional criteria and thus use the residual approach in a lease, the entity i) would need to lease similar assets (for example, similar asset types and in a similar location) for a very broad range of amounts indicating a representative standalone price is not discernible from past transactions or ii) has not previously leased the applicable type of assets and is unable to determine a standalone price because there are no similar transactions that the entity can use as a benchmark. It should be noted that the criteria in paragraph 606-10-32-34(c) are deliberately very restrictive. Consequently, although a lessee could use the residual method if the criteria are met, it is considered very unlikely that this will occur frequently in practice.

REMEASURING AND REALLOCATING THE CONSIDERATION

Inevitably, modifications to contracts and changes in facts and circumstances may occur during the contract term. Paragraph 842-10-15-36 requires a lessee to remeasure the consideration in the contract and to reallocate the consideration to the components in the contract when certain events occur. Those are:

- ▶ The effective date of a contract modification that is not accounted for as a separate contract per paragraph 842-10-25-8, and
- ▶ Remeasurements of the lease liability, such as a remeasurement resulting from a change in the lease term or change in assessment of a lessee purchase option, per paragraph 842-20-35-4.

Events that require remeasurement will be discussed in further detail in article 5, [Accounting for Leases - Lessees](#).



However, a lessee's requirement to reallocate the consideration in the contract would depend on whether it elected the practical expedient not to separate for the relevant asset class.

SEPARATING COMPONENTS - LESSORS

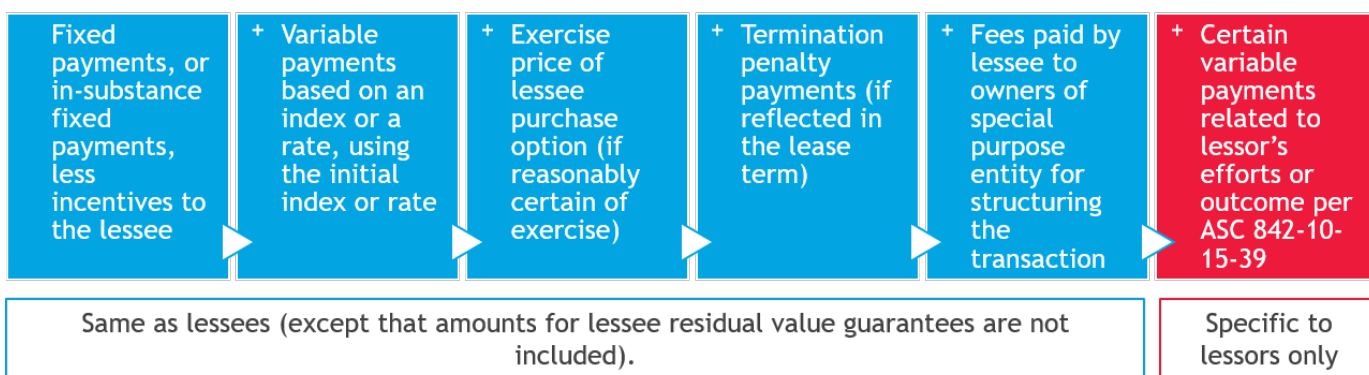
DETERMINING THE CONSIDERATION IN THE CONTRACT

The consideration in the contract for a lessor includes *as a starting point* the payments described in paragraphs 842-10-15-35 and 842-10-30-5 (that is, the same payment amounts as those determined by the lessee, except that a lessor does not include amounts probable of being owed under a lessee residual value guarantee).

The consideration also includes certain variable payments related to the lessor's efforts in transferring (or an outcome in transferring) one or more goods or services that are not leases, consistent with the guidance in ASC 606.

There are also additional considerations for sales taxes and similar taxes, and reimbursements of lessor costs which we will discuss separately.

The following graph summarizes a lessor's consideration in the contract.



VARIABLE PAYMENTS RELATED TO LESSOR'S EFFORTS OR OUTCOME

The consideration for a lessor includes variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in ASC 606 when they relate specifically to:

- ▶ the lessor's efforts to transfer one or more goods or services that are not leases, or
- ▶ an outcome from transferring one or more goods or services that are not leases.

Those amounts are included in the consideration in the contract if it is probable that a significant revenue reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved (consistent with the constraint on variable consideration in ASC 606).

However, if the terms of a variable payment amount (other than those that depend on an index or a rate) relate to a lease component, *even partially*, the lessor does not include those payments in the consideration in the contract.

Example 14 in ASC 842-10-55 illustrates this guidance to a contract for the lease of equipment that includes maintenance for which consideration is a fixed amount plus a variable payment amount based on a minimum number of hours that the asset operates at a specified level of productivity. In Cases B and C of that example, the variable payment amounts for maintenance are included in the consideration in the contract because the maintenance services on the equipment are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

In real estate scenarios, examples of variable payments that would not be included in the consideration in the contract include variable payments of the lessor's property taxes and insurance, or payments based on sales of the lessee. This is because those payment amounts relate at least partially to the lease component. Example of variable payments that would be included in the consideration in the contract include payments for common area maintenance (CAM) services if such payments relate solely to the lessor's efforts to provide the CAM services.

However, even if variable payments relate specifically to the nonlease component(s), when a lessor elects the practical expedient not to separate for the asset class (assuming the nonlease component qualifies for combination with the lease component and the lease component is the predominant component), the variable payments are not included in the consideration in the contract. This is because the lessor elected the practical expedient and the variable payments now relate to the lease component. See further discussion below on the lessor practical expedient.

Assessment on Variable Payments by Lessor in accordance with ASC 606

The treatment of variable payments other than those based on an index or a rate is one major difference in the determination of the consideration in the contract between lessees and lessors. Determining whether certain variable payments relate solely to a nonlease component may require significant judgment, as may estimating the consideration, subject to the constraint in accordance with ASC 606. Lessors that engage in transactions with significant variable payments may consider developing a policy to assess in a consistent manner the nature of variable payments including earning mechanisms and triggering points for payment to assess whether such payments are solely related to a nonlease component in accordance with paragraph 842-10-15-39.

REIMBURSEMENT OF LESSOR COSTS

As previously explained, lessor costs such as property taxes on the underlying asset and insurance that protects the lessor's asset, are not considered a component of the contract. Absent guidance to the contrary, a lessor would be required to report such lessor costs on a gross basis (i.e., as revenue and expenses) whether the lessee reimburses the lessor or pays such costs on lessor's behalf to a third-party. However, when the lessee pays a third-party directly, lessors noted that reporting those costs in profit or loss would be costly and complex because the lessor may not have visibility into the actual amounts paid by the lessee and therefore may need to estimate those amounts. Lessors also questioned the usefulness of amounts reported because those often would be based on estimates that are affected by lessee-specific factors (for example, insurance premiums paid by the lessee for a policy that protects both the lessor's asset and other assets that the lessee owns, amount of deductible selected by the lessee, etc.).

Accordingly, notwithstanding the guidance on variable payments discussed previously, the accounting for lessor costs is as follows:

Lessee pays lessor costs directly to a third-party	Lessor pays costs and is reimbursed by lessee
<ul style="list-style-type: none"> ▶ Exclude from variable payments. ▶ In other words, treat like a lessee cost, which does not affect the accounting for the lease. 	<ul style="list-style-type: none"> ▶ Account for costs excluded from the consideration in the contract as lessor costs (i.e., as variable payments). ▶ In other words, recognize on a gross basis.

SALES TAXES AND SIMILAR TAXES

A lessor can make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. Absent that practical expedient, the analysis of sales taxes and similar taxes could be costly and complex depending on the number of jurisdictions and the variation of, and changes in, tax laws among those jurisdictions.

This practical expedient is consistent with the practical expedient provided in ASC 606 and reduces costs and complexity in assessing sales taxes and similar taxes. When the lessor makes the election, it should comply with the disclosure requirements in paragraph 842-30-50-14.

However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (e.g., property taxes - see discussion above) are excluded from the scope of this election.

PRACTICAL EXPEDIENT NOT TO SEPARATE

In July 2018, the FASB issued ASU 2018-11, which provides lessors with a practical expedient similar to lessees to not separate lease and nonlease components by asset class, if certain criteria are met.

As provided by paragraph 842-10-15-42A, a lessor may, as an accounting policy election by asset class, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single lease component if the following three conditions are met:

- ▶ The nonlease component(s) otherwise would be accounted for under ASC 606,
- ▶ The timing and pattern of transfer of the lease component and nonlease component(s) associated with that lease component are the same, and
- ▶ The lease component, if accounted for separately, would be classified as an operating lease.

Also, in accordance with paragraph 842-10-15-42B, for arrangements that qualify for the scope of this practical expedient, the way in which a lessor accounts for the combined component depends on predominance:

Nonlease component(s) is (are) predominant	Lease component is predominant
▶ Account for combined component as a single performance obligation under ASC 606.	▶ Account for the combined component as a single lease component under ASC 842.
▶ Use same measure of progress used in determining whether the arrangement qualified for the expedient (i.e., the lessor uses a straight-line measure of progress).	▶ Account for the lease as an operating lease.
▶ Account for all variable payments related to any good or service, <i>including the lease</i> , that is part of the combined component under the variable consideration guidance in ASC 606.	▶ Account for all variable payments related to any good or service that is part of the combined component as variable <i>lease</i> payments.

In assessing predominance, a lessor should evaluate whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

Also, when a contract includes a lease component and multiple nonlease components, some of the nonlease components may meet the conditions to be combined with the lease component, while other nonlease components may not (for example, a nonlease component that transfers at a point in time). In this case, this does not preclude the lessor from applying the practical expedient to the contract. However, the lessor is required to separate and allocate the consideration in the contract between the combined component on one hand (i.e., the lease component and nonlease components that meet the conditions) and the nonlease components (those that do not qualify) on the other hand.

Application Considerations for Lessor Practical Expedient Not to Separate

The following considerations are important in understanding and evaluating whether a lessor qualifies for the practical expedient:

- ▶ The practical expedient applies only to nonlease components that otherwise would be accounted for under ASC 606. It does not apply, for example, to a contract that includes a lease component and a loan component accounted for under ASC 310 on receivables.
- ▶ Determining whether the lease component would be classified as an operating lease if accounted for separately generally should not require a detailed quantitative analysis and may often be determined using either a reasonable qualitative assessment, or a simplified quantitative approach in which all payments in the contract are used to perform the present value classification test (to test if the lease would be classified as an operating lease even with all payments) in addition to assessing the other lease classification tests. However, in certain situations, additional analysis may be required.
- ▶ Because the timing and pattern of transfer of the nonlease components must be the same as the timing and pattern of transfer of the lease, the nonlease components will generally need to be recognized on a straight-line basis (i.e., over time, time-based) to qualify for the practical expedient (see Note 1 below). Performance obligations satisfied over time but using a measure of progress different from a time-elapsed measure of progress, or performance obligations satisfied at a point in time (even if satisfied ratably throughout the lease term), do not qualify for the practical expedient (See Note 2).
- ▶ A lessor should be able to reasonably determine which component is predominant (i.e., a lessor does not have to perform a detailed quantitative analysis or theoretical allocation). We also believe entities may use a >50% threshold in determining which component is predominant for this lessor practical expedient as discussed by the FASB in a public Board meeting.

We believe many lessor entities (including real estate entities and cable providers, to name a few) will take advantage of this lessor practical expedient, as it generally may enable them to account for their transactions under ASC 842 or ASC 606 in a manner similar to how they have accounted for them in the past, and how users of their financial statements have used the information.

Note 1: Paragraph 842-30-25-11(a) requires a lessor to recognize operating lease payments on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which the lessee benefits from use of the underlying asset. However, in practice, it generally is infrequent for anything other than straight-line recognition to be applied.

Note 2: It is important to note that while the pattern of transfer of the nonlease components must be the same as the lease component, the recognition of revenue does not have to be the same. For example, if the contract includes variable consideration, the recognition pattern under ASC 606 for the nonlease component may not be the same as the pattern of recognition under ASC 842. The fact that the two different standards provide for differences in the recognition of variable consideration would not preclude a lessor from electing the practical expedient if the timing and pattern of transfer of the lease and nonlease components are the same.

Applying Lessor Practical Expedient May Change Amount of Consideration in the Contract

A key consequence of the lessor practical expedient not to separate is that it may change the consideration in the contract for a lessor when the contract includes variable payments. For example, a real estate contract may provide for the right to use an office building along with common area maintenance (CAM) services. The contract may stipulate that the lessee will pay a fixed payment amount per month and will reimburse the lessor for property taxes, insurance, and CAM costs incurred by the lessor. Absent the lessor applying the practical expedient for this asset class, the lessee's reimbursements for CAM services would meet the conditions in paragraph 842-10-15-39 to be included in the consideration in the contract because the payments relate specifically to the lessor's efforts in transferring a good or service to the lessee that is not the lease. However, when the lessor has elected and applies the practical expedient for this asset class, the contract includes only one lease component (assuming there are no other nonlease components in the contract that do not qualify for the practical expedient). Accordingly, variable payments the lessee will make to the lessor under the contract are all considered to relate to the lease component (even the payments for CAM services), and therefore no variable payment amounts will be included in the consideration in the contract. We illustrate this in Examples 5B and 5C below.

ALLOCATION OF CONSIDERATION TO LEASE AND NONLEASE COMPONENTS

If a lessor does not elect the practical expedient not to separate, or elects it but the criteria for combination are not met for one or more nonlease components, the lessor allocates the consideration in the contract using the revenue guidance in paragraphs 606-10-32-28 through 32-41.

Also, as previously discussed, lessors should include in the consideration in the contract (subject to the constraint) variable payments that relate specifically to:

- ▶ The lessor's efforts to transfer one or more goods or services that are not leases, or
- ▶ An outcome from transferring one or more goods or services that are not leases.

If included in the consideration, those variable payment amounts are allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

However, if the terms of the variable payment amount (other than those that depend on an index or a rate) relate to a lease component, *even partially*, the lessor cannot recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor should allocate those payments to the lease and nonlease components of the contract. In doing so, the allocation should be on the same basis as the initial allocation of the consideration in the contract, or the most recent modification not accounted for as a separate contract, unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). After this allocation then:

- ▶ Variable payment amounts allocated to the lease component(s) are recognized as income in profit or loss in accordance with ASC 842,
- ▶ Variable payment amounts allocated to nonlease component(s) are recognized in accordance with other Topics such as ASC 606.

A lessor also allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease components or nonlease components to which those costs relate.

Example 4B - Lease of Land and Building (Continued) - Lessor Accounting**FACTS**

- ▶ Let's continue with Example 4 in which Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The lease requires Lessor to perform landscaping services for Lessee.
- ▶ Lessee pays a fixed monthly payment of \$12,000 per months in arrears which includes rent, landscaping services, and reimbursement of Lessor's costs.
- ▶ Assume there are no lease incentives or initial direct costs.

WHAT ARE THE COMPONENTS?**SCENARIO 1: Lessor elects practical expedient not to separate for this asset class.**

- ▶ Lessor determines that it meets the scope conditions of the practical expedient under paragraph 842-10-15-42A because:
 - The landscaping services would otherwise be accounted for under ASC 606.
 - The lease component would be accounted for as an operating lease. Lessor performed this assessment qualitatively considering the terms of the contract (Additional guidance on lease classification will be covered in the next article in this series, [Lease Classification and Key Terms](#)).
 - The lease component and nonlease component have the same timing and pattern of transfer (i.e., overtime, time-based). Lessor determined that the pattern of transfer of the landscaping services would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- ▶ Lessor also determines that the nonlease component is not the predominant component, because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- ▶ Lessor notes that paragraph 842-10-15-42C is not applicable because there is only one nonlease component and it qualifies for the practical expedient not to separate.
- ▶ Accordingly, the contract includes one lease component (i.e., the combined components), which Lessor accounts for as an operating lease under ASC 842 consistent with paragraph 842-10-15-42B.

SCENARIO 2: Lessor does not elect practical expedient not to separate for this asset class.

- ▶ As previously evaluated in Example 4, the contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services).
- ▶ Also, Lessor determines under ASC 606 that its landscaping services represent a single performance obligation.

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ There are no variable payments in the contract. Therefore, the guidance in paragraph 842-10-15-39 does not apply.
- ▶ The consideration in the contract for Lessor is $\$12,000 \times 12 \text{ months} \times 5 \text{ years} = \$720,000$.

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?SCENARIO 1: Lessor elects practical expedient not to separate for this asset class.

- ▶ The consideration in the contract of \$720,000 is allocated entirely to the lease component.
- ▶ Lessor accounts for the lease component as an operating lease in accordance with paragraph 842-10-15-42B, and therefore recognizes \$720,000 on a straight-line basis over the lease term.

SCENARIO 2: Lessor does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessor allocates the consideration in the contract to the lease and nonlease components on a relative standalone selling price basis. Lessor determines that the standalone selling prices for the lease component and nonlease component are \$680,000 and \$50,000, respectively, using the guidance in ASC 606.
- ▶ Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

	Standalone Selling Price	Relative Standalone Selling Price
Lease component	\$680,000	\$670,685 (93.15%)
Maintenance component	50,000	49,315 (6.85%)
	<u>\$730,000</u>	<u>\$720,000</u>

- ▶ The amount of the consideration in the contract allocated to the lease component (\$670,685) is used to account for the lease component (e.g., assess lease classification, recognize lease revenue, etc.).
- ▶ The amount of consideration for the landscaping component (\$49,315) is accounted for under ASC 606.

Example 5B - Lease of Office Space (Continued) - Lessor Accounting, Practical Expedient Not to Separate Is Elected**FACTS**

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.
- ▶ Lessor elects the practical expedient not to separate for this asset class.

WHAT ARE THE COMPONENTS?

- ▶ Lessor determines that it meets the scope conditions of the practical expedient in paragraph 842-10-42A because:
 - The CAM services would otherwise be accounted for under ASC 606.
 - The lease component would be accounted for as an operating lease. Lessor performed this assessment qualitatively considering the terms of the contract (Additional guidance on lease classification will be covered in the next article in this series, [Lease Classification and Key Terms](#)).
 - The lease component and nonlease component have the same timing and pattern of transfer (i.e., over time, time-based). Lessor determined that the pattern of transfer of CAM would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- ▶ Lessor also determines that the nonlease component is not the predominant component, because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- ▶ Lessor notes that paragraph 842-10-15-42C is not applicable because there is only one nonlease component and it qualifies for the practical expedient not to separate.
- ▶ Accordingly, the contract includes one lease component (i.e., the combined components).

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The consideration in the contract starts with the same amount as determined by Lessee, which is \$50,000 X 12 months X 5years = \$3,000,000
- ▶ There are variable payments in the contract. Therefore, Lessor applies the guidance in paragraph 842-10-15-39. However, Lessor determines that the payments Lessee will make to Lessor for its prorata share of real estate taxes and insurance are variable payments that are not based on an index or a rate, and they relate to the lease component.
- ▶ Also, although the CAM payments relate specifically to the CAM services, Lessor elected the practical expedient and therefore those payments are considered to relate to the lease component.
- ▶ Accordingly, the expected amounts for property taxes, insurance and CAM are excluded from the consideration in the contract in accordance with paragraph 842-10-15-40.
- ▶ The consideration in the contract for Lessor is \$3,000,000.

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

- ▶ The lease is accounted for as an operating lease consistent with paragraph 842-10-15-42B.
- ▶ The consideration in the contract of \$3,000,000 is allocated entirely to the lease component and is used to recognize lease revenue on a straight-line basis over the lease term.
- ▶ Because Lessee reimburses Lessor for property taxes and insurance (as opposed to paying directly a third-party), Lessee's payments for its prorata share of those activities are considered lessor costs in accordance with paragraph 842-10-15-40A and are recognized on a gross basis in profit or loss.
- ▶ Since Lessor elected the practical expedient not to separate, variable payments for property taxes, insurance and CAM are considered variable lease payments and are recognized in accordance with paragraph 842-30-25-11(b), which is when the changes in facts and circumstances on which the variable payments are based occur.

Example 5C - Lease of Office Space (*Continued*) - Lessor Accounting, Practical Expedient Not to Separate Is Not Elected

FACTS

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrear and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.
- ▶ Lessor does not elect the practical expedient not to separate for this asset class.

WHAT ARE THE COMPONENTS?

- ▶ As previously evaluated in Example 5, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- ▶ Also, Lessor determines under ASC 606 that its CAM services represent a single performance obligation.

WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The consideration in the contract starts with the same amount as determined by Lessee, which is $\$50,000 \times 12 \text{ months} \times 5 \text{ years} = \$3,000,000$.
- ▶ There are also variable payments in the contract. Therefore, Lessor applies the guidance in paragraph 842-10-15-39.
- ▶ Lessor determines that Lessee's payments for CAM services relate specifically to Lessor's efforts to transfer the CAM services.
- ▶ Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13.
 - Lessor estimates that it will be entitled to receive \$240,000 in variable payments for the CAM services ($\$4,000 \times 12 \times 5 \text{ years} = \$240,000$).
 - Lessor also determines that it is probable that including that amount in the consideration would not result in a significant reversal in cumulative revenue when the uncertainty of the payments is resolved.
 - Accordingly, Lessor includes the amount it expects to be entitled to receive for the CAM services of \$240,000 in the consideration in the contract.
- ▶ The other payments Lessee will make to Lessor for its prorata share of real estate taxes and insurance are not based on an index or a rate. They also relate at least partially to the lease component. Accordingly, the expected reimbursement amounts for property taxes and insurance are not included in the consideration in the contract in accordance with paragraph 842-10-15-40.
- ▶ The consideration in the contract for Lessor is $\$3,240,000$ ($3,000,000 + 240,000$).

WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

- ▶ Lessor allocates the consideration in the contract to the lease and nonlease components using the guidance in ASC 606. For example, if the CAM charges are not at their standalone selling price (for example, CAM services are charged at cost without a profit margin), one acceptable allocation approach may be for Lessor to allocate the entire amount of expected CAM reimbursements to the CAM component, plus a portion of the fixed consideration to reflect an appropriate profit margin on the CAM services, if that reasonably depicts the consideration Lessor expects to be entitled for each of the lease component and CAM component.
- ▶ The amount of the consideration in the contract allocated to the lease component is then used to account for the lease component under ASC 842 (e.g., assess lease classification, recognize lease revenue on a straight-line basis over the lease term if an operating lease, etc.).
- ▶ The amount of consideration allocated to CAM services is accounted for in accordance with the guidance on satisfaction of performance obligations in paragraphs 606-10-25-23 through 25-37. In this case, Lessor determines that CAM services are provided over time, using a time-based measure of progress (i.e., on a straight-line basis).
- ▶ Lessor will consider the guidance on variable consideration in ASC 606 and update the amounts it expects to be entitled for CAM services each reporting period. Lessor will allocate those changes consistent with its initial allocation. For example, if Lessor initially allocated the estimated CAM payments entirely to the CAM component, subsequent changes to that estimate may be allocated entirely to the CAM component.
- ▶ Because Lessee reimburses Lessor for property taxes and insurance (as opposed to paying directly a third-party), Lessee's payments for its prorata share of those activities are considered lessor costs in accordance with paragraph 842-10-15-40A and are recognized on a gross basis in profit or loss.
- ▶ Also, Lessor will allocate the variable payments for property taxes and insurance to the lease and nonlease components in accordance with paragraph 842-10-15-40; that is, on the same basis as the initial allocation of the consideration in the contract (or most recent modification not accounted for as a separate contract, if any), unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component. For example, Lessor may allocate the entire payments for property taxes and insurance to the lease component if that is consistent with the initial allocation performed and the allocation objective.
- ▶ Then,
 - Variable payment amounts allocated to the lease component are recognized as income in profit or loss in accordance with paragraph 842-30-25-11(b) which is when the changes in facts and circumstances on which the variable payments are based occur.
 - Variable payment amounts allocated to the nonlease component, if any, are recognized in accordance with ASC 606.

REMEASURING AND REALLOCATING THE CONSIDERATION

A lessor remeasures and reallocates the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract under paragraph 842-10-25-8. This also includes situations described in paragraph 842-10-35-3 (for example, when the lessee exercises a renewal or purchase option that the lessor previously determined was not reasonably certain of exercise).

Also, a lessor allocates subsequent changes in variable consideration in accordance with the requirements in paragraphs 606-10-32-42 through 32-45. For example, in Example 5C above the lessor included estimated CAM payments in the consideration in the contract. If the estimate subsequently changes, the additional consideration should be allocated to the lease and nonlease components on the same basis that the initial consideration was allocated.

PORTFOLIO APPROACH

Paragraph 120 in the Basis for Conclusions in ASU 2016-02 indicates that ASC 842 permits an entity (lessee or lessor) to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of ASC 842 to the individual leases in the portfolio. Paragraphs 842-20-55-18 through 55-20 also provide an example in which the portfolio approach is utilized in determining the discount rate for the lease.

The portfolio approach may also be used to account for multiple lease components that have the same characteristics including commencement date, lease term, and lease classification, such as a lease of three vehicles, or a lease of multiple floors in a multi-floor building. However, the application of the portfolio approach could result in additional complexity when the entity applies the subsequent measurement guidance of ASC 842 (for example, for a lessee, on impairment and abandonment considerations, or contract modification considerations - see upcoming article on [Accounting for Leases - Lessees](#) for further details).

CONTRACT COMBINATION

Two or more contracts must be combined, at least one of which is or contains a lease, when they are entered into at or near the same time with the same counterparty (or related parties) and consider those contracts as a single transaction if either:

- ▶ They were negotiated as a package with the same commercial purpose,
- ▶ The amount of consideration to be paid in one contract depends on the price or performance of the other one, or
- ▶ The rights to use the underlying assets conveyed in the contracts are a single lease component based on the separation guidance described above.

Combination Guidance Aligned with Revenue Guidance

The guidance in paragraph 842-10-25-19 on contract combination is consistent with the guidance in paragraph 606-10-25-9 on combining revenue contracts. This linkage was intentional, as the new lease standard incorporates concepts from the new revenue recognition guidance.

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