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# New Developments Summary

## Leases redefined

**New leasing standard puts greater pressure on lease identification for lessees**

### Summary

As companies progress toward implementing the FASB's new lease accounting standard, practitioners are faced with a threshold question: Which contracts are subject to the new lease accounting model? This question is particularly important for lessees to consider, because operating lease accounting for lessees is changing dramatically under ASU 2016-02, *Leases,* which is codified in ASC 842, *Leases*. Under the new standard, lessees are required to recognize assets and liabilities on their balance sheets for nearly *all* leases, including operating leases, which have been historically off-balance sheet. Therefore, whether or not a contract meets the definition of a lease under ASC 842 will significantly affect the required accounting for lessees, since operating leases will no longer be accounted for similarly to nonlease executory contracts.

Although on the surface, the definition of a lease under ASC 842 appears consistent with the guidance it replaces in ASC 840, there are two critical factors that will challenge practitioners. First, the implementation guidance underlying the definition of a lease is changing under ASC 842, placing an emphasis on evaluating whether a customer has both the right to receive economic benefits from using an asset and the right to control the asset's use. Second, entities might not have carefully considered in the past whether certain types of contracts either are or contain leases, since previously that analysis has not materially affected the accounting for those contracts.

This bulletin examines in detail the new definition of a lease and the related implementation guidance in ASC 842. The views expressed are based on our evaluation of implementation questions raised by practitioners to date. As implementation efforts proceed, our views could evolve, and we expect that new issues and positions will emerge as the effective date of the new leasing guidance draws near.



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## Introduction

The FASB's new lease accounting standard, ASU 2016-02, *Leases,* which is codified in ASC 842, *Leases*, requires lessees to recognize most leases on their balance sheets by recording a "right of use" asset and a lease liability. Under ASC 842, the inflection point for on-balance sheet versus off-balance sheet accounting is whether a contract meets the definition of a lease. In contrast, under the legacy guidance in ASC 840, lessees have capitalized leases depending on whether the lease is classified as a "capital" or an "operating" lease.

The new lease accounting standard amends the current definition of a lease. While a lease continues to convey the right to use property, plant, and equipment for a period of time, the new guidance eliminates certain of the criteria under legacy guidance used to identify a lease, which focus on a customer's right to operate, physically access, or receive substantially all of the output from an asset.

For example, a contract that previously met the definition of a lease solely because the customer is required to purchase all of the output from an identified asset at a variable price per unit that does not equal the market price for the same product might no longer meet the definition of a lease under the new standard. For such a contract to fall within the scope of the new lease definition, it must convey to the customer the right to receive substantially all of the economic benefits from using the asset and the right to direct the use of the asset. Determining whether these criteria are met can be a complex and judgmental process.

In addition, entities might find that contracts previously qualifying for off-balance sheet executory contract accounting (either as a nonlease contract or as an operating lease) were never previously scrutinized to determine whether or not they meet the definition of a lease, because the conclusion did not materially affect the accounting outcome. Under the new standard, the distinction for a customer between a lease and nonlease contract is stark: A nonlease contract might continue to require off-balance sheet accounting, whereas a lease contract would likely require on-balance sheet accounting, regardless of its classification.

## Definition of a lease

ASC 842 defines a "lease" as a contract or part of a contract that conveys the right to control the use of identified property, plant, and equipment for a period of time in exchange for consideration. An entity determines whether a contract conveys the right to control the use of an asset by assessing whether the customer has both (a) the right to obtain substantially all of the economic benefits from using the asset, and (b) the right to direct the use of the asset. If both of these criteria are met, along with the other components of the definition of a lease, then a contract is or contains a lease. These criteria are explained in further detail in the following sections.

**FASB Accounting Standards Codification**

**Identifying a Lease**

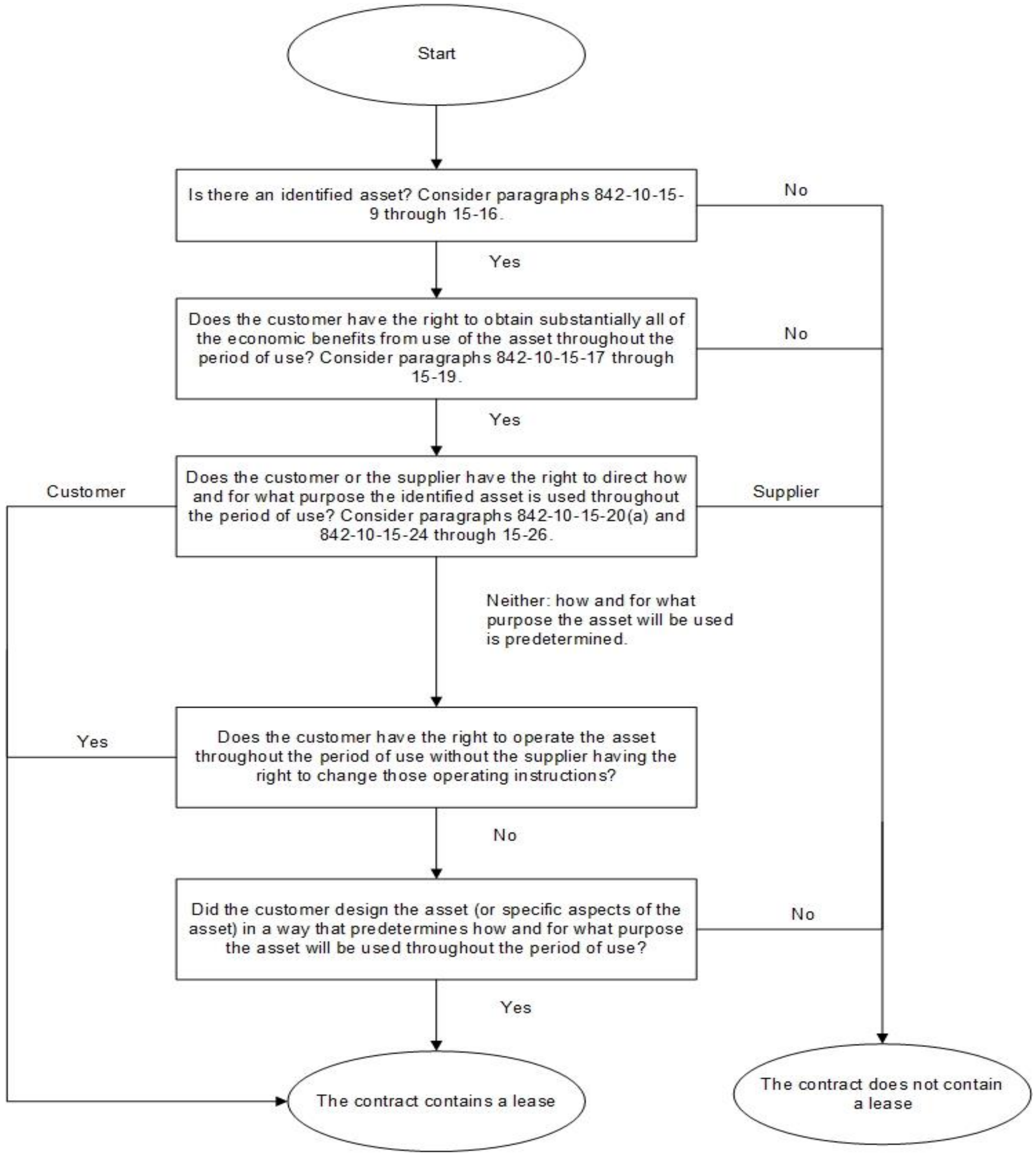
**ASC 842-10-15-2**

At inception of a contract, an entity shall determine whether that contract is or contains a lease.

**ASC 842-10-15-3**

A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

The following flowchart from ASC 842-10-55-1 illustrates the process for determining whether a contract contains a lease.




## Period of time

A key characteristic of a lease is that it conveys the right to use an asset for a certain period of time. That period of time, known as the "period of use," might comprise only a portion of the term of a contract that is or contains a lease, and might commence at a later date than the inception date of the contract. Understanding the distinction between the inception date of a contract and the commencement date of a lease, as well as the distinction between the contract term and the period of use, is critical to properly identify and account for leases under ASC 842.

## Inception date versus commencement date

An entity must determine whether a contract is or contains a lease at the contract inception date, which is the date the contract is executed. This date could be different from the commencement date of a lease, which is the date a lessor makes an underlying asset available for the lessee's use. A lease component of a contract is required to be measured and recognized at the commencement date of the lease.

**FASB Accounting Standards Codification**

**Commencement Date**

**ASC 842-10-55-19**

In some lease arrangements, the lessor may make the underlying asset available for use by the lessee (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes lease payments under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

**ASC 842-10-55-20**

The contract may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternatively, some contracts require the lessee to make lease payments when it takes possession of or is given control over the use of the underlying asset. The timing of when lease payments begin under the contract does not affect the commencement date of the lease.

**ASC 842-10-55-21**

Lease costs (or income) associated with building and ground leases incurred (earned) during and after a construction period are for the right to use the underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. Therefore, lease costs (or income) associated with ground or building leases that are incurred (earned) during a construction period should be recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. That guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases.

In many lease arrangements, the inception date matches the commencement date of the lease, meaning the leased asset is available for the lessee's use concurrent with execution of the contract.

However, in some cases, there is a period of time that elapses between the inception date and the commencement date of the lease.

**Example: Distinguishing lease inception and commencement dates**

On January 1, a lessee executes a contract with a lessor for the right to use an office building for a period of five years. However, the lessor must make repairs to the building before granting the lessee access, including repairs to the building's foundation. Once the repairs are completed on March 1, the lessee is granted access to the building, at which time, the lessee's contractor can begin installing leasehold improvements. In this example, the contract inception date is January 1, and the commencement date of the lease is March 1.

Now, assume that the lessee is not required to begin making lease payments until the contractor completes construction on leasehold improvements, which occurs on June 1.The commencement date of the lease is still March 1, because that is when the lessor makes the asset available for use by the lessee, regardless of whether the lessee's obligation to make lease payments is deferred for some period of time.

### Contract term versus period of use

Entities should also be aware of the difference between a lease's contract term and the period of use of a leased asset. Determining whether a contract meets the definition of a lease depends on an assessment of the customer's rights during the period of use, which might comprise only a portion of the contract term.

**Period of Use**: The total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time).

The period of use represents the time period during which an identified asset is used to fulfill a contract with a customer, and includes nonconsecutive periods of time. For example, a tax preparer might enter into a three-year contract with a building owner to lease certain office space only during the months of January through April each year to accommodate contractors that the preparer hires during its busiest time of the year. From May through December of each of those years, the lessor leases the space to other tenants. In this example, the contract term is three years, but the period of use is twelve months, consisting of three nonconsecutive four-month periods. For purposes of determining whether this contract contains a lease under ASC 842, the parties must focus on the rights conveyed to the customer during the period of use rather than throughout the contract term.

## Identified asset

A lease must specify, either explicitly or implicitly, an identified asset.

**FASB Accounting Standards Codification**

**Identified Asset**

**ASC 842-10-15-9**

An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

When an asset is not explicitly identified in the contract, an entity must determine whether the contract implicitly identifies an asset by simply requiring the use of an asset to fulfill the contract from its commencement. In other words, even if the customer cannot identify the particular asset that will be used to fulfill the contract, the fact that an asset is required to fulfill the contract is sufficient to implicitly identify an asset.

The Board explained this concept in the Basis for Conclusions (BC) in ASU 2016-02.

**ASU 2016-02 Basis for Conclusions**

**BC128**

The first requirement for a contract to meet the definition of a lease in Topic 842 is that a customer should control the use of identified property, plant, and equipment (an identified asset). The requirement that there be an identified asset is substantially the same as the requirement in previous GAAP that a lease depends on the use of a specified asset. It is important to know what the asset is to assess whether the customer has the right to control the use of that asset and, for example, to determine which asset to derecognize for lessors with sales-type or direct financing leases. Nonetheless, when assessing whether there is an identified asset, an entity does not need to be able to identify the particular asset that will be used to fulfill the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an asset is needed to fulfill the contract from commencement. If that is the case, an asset is implicitly specified. Topic 842 clarifies that if a supplier has a substantive right to substitute the asset throughout the period of use, there is not an identified asset and the contract does not contain a lease. That is because the supplier (and not the customer) controls the use of the asset if it can substitute that asset throughout the period of use, thereby deciding for what purpose the asset is used.

While the concept of an identified asset might seem broad on account of how an asset could be implicitly specified in a contract, the population of contracts that contain identified assets is narrowed somewhat by the requirement that customers and suppliers must consider whether a contract contains substantive substitution rights, as explained in the following section.

## Substitution rights

A contract does not specify an identified asset if the supplier has a substantive substitution right that is exercisable throughout the period of use.

**FASB Accounting Standards Codification**

**Substantive Substitution Rights**

**ASC 842-10-15-10**

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

**ASC 842-10-15-11**

An entity’s evaluation of whether a supplier’s substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include, but are not limited to, the following:

a. An agreement by a future customer to pay an above-market rate for use of the asset

b. The introduction of new technology that is not substantially developed at inception of the contract

c. A substantial difference between the customer’s use of the asset, or the performance of the asset and the use or performance considered likely at inception of the contract

d. A substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract.

**ASC 842-10-15-12**

If the asset is located at the customer’s premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier’s premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

**ASC 842-10-15-13**

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

**ASC 842-10-15-14**

> The supplier's right or obligation to substitute an asset for repairs or maintenance, if the asset is not operating properly, or if a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset.
>
> **ASC 842-10-15-15**
>
> If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.

A substitution right is considered "substantive" if the supplier both (1) has the practical ability to substitute alternative assets throughout the period of use, and (2) would benefit economically from exercising this right. For example, a supplier that owns a fleet of railcars could enter into a contract with a customer to transport the customer's goods via railcar for a specified period of time. If the supplier has the practical ability to substitute certain railcars for others (that is, alternative cars are available and the supplier does not require the customer's permission to substitute them) and would benefit economically from exercising its substitution right (for example, using cars that are located closest to the point of origin of a shipment), then the contract would not be a lease because it lacks an identified asset.

If a substitution right is contingent on the occurrence of a future event that, at inception of the contract, is considered not likely to occur, then an entity should exclude that contingent right from its analysis of substitution rights in the contract. ASC 842-10-15-11 gives four examples of contingent events that would not be considered likely to occur as of the contract inception date:

- A future customer agrees to pay an above-market rate to use the asset.
- New technology is introduced that was not substantially developed at contract inception.
- The customer's use or performance of the asset differs from what was likely at contract inception.
- The market price of the asset changes significantly from what was expected at contract inception.

If a contract contains supplier substitution rights that are triggered by any of these events or by other events that are not deemed likely to occur at the inception date, then those substitution rights are not substantive and would not preclude the contract from containing an identified asset.

If a supplier can exercise its right to substitute an asset only on or after a particular date or when a specified event occurs, then the supplier does not have the practical ability to substitute alternative assets throughout the period of use, and the substitution right would not be substantive. For this reason, an entity is unable to avoid lease accounting by inserting a substitution right into a contract that becomes exercisable after the lease commences.

Customers are not required to take exhaustive measures to determine whether a contract contains a substantive substitution right. Rather, if a customer cannot "readily determine" whether a substantive substitution right exists, then the customer should assume that the contract lacks a substantive substitution right.

**Example: Substantive substitution rights**

A contract to use a copy machine for a period of time allows the supplier to replace the machine under certain circumstances, such as when the machine is inoperable. When evaluating whether this substitution right is substantive, the customer considers whether the supplier has the practical ability to exercise its substitution right and would benefit economically from doing so. The copy machine is located on the customer's premises and the supplier is unable to exercise its substitution right without the customer's permission to access the machine, which limits the supplier's practical ability to exercise its substitution right. In addition, the asset's location makes substitution more costly for the supplier than if the asset was located on the supplier's premises. Therefore, the customer determines that it is unlikely the supplier would benefit from exercising its substitution right given the costs involved with obtaining permission to access the equipment and sending personnel to the customer's premises to substitute new equipment.

If the customer cannot readily determine whether the supplier might benefit from exercising its substitution right, the customer should assume that the right is not substantive.

The guidance on determining whether a contract contains a substantive substitution right is written in a way that increases the likelihood that a customer will determine that a contract contains an identified asset. In other words, a customer unable to readily determine whether a substantive substitution right exists would simply assume that such a right does not exist and that the contract contains an identified asset.

### *Throughout the period of use*

For a substitution right to be substantive, it must provide the supplier with the right to substitute the asset throughout the "period of use," as defined in ASC 842. It is important to properly identify the period of use before considering whether a substitution right is substantive.

**Example: Period of use**

A customer enters into a two-year contract with a supplier to use specified manufacturing equipment only from October through December each year. The contract term is two years, but the period of use is only six months (two nonconsecutive three-month periods). The existence of a supplier substitution right needs to be assessed only for the period of use, which is the October through December timeframe of each year of the contract.

## Portions of assets

Some contracts provide the customer with the right to use a capacity portion of an asset. For example, a customer has the right to use 30 percent of a fiber optic cable's capacity. For a capacity portion of an asset to represent an identified asset, it must be physically distinct. A stated percentage of a fiber optic cable's capacity is not physically distinct.

**FASB Accounting Standards Codification**

**Portions of Assets**

**ASC 842-10-15-16**

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Other contracts provide a customer with the exclusive right to use a specific capacity portion of an asset. ASC 842-10-15-16 provides examples of physically distinct portions of assets, such as the floor of a multilevel office building or a pipeline lateral that connects an oil-producing property to a main pipeline system. Likewise, an identified strand within a fiber optic cable represents a physically distinct portion of the fiber optic cable.

A capacity portion of an asset depends on the remaining capacity of the asset to function (for example, the second floor of a building cannot function without the first floor) and represents only a portion of a larger asset (the second floor of a ten-story building represents approximately one-tenth of the building's capacity). However, as long as the capacity portion is physically distinct, it could be an identified asset in a lease.

In addition, if a contract provides the customer with the right to use "substantially all" of the asset's capacity, then the capacity portion of the asset could qualify as an identified asset. While the term "substantially all" is not defined in ASC 842, the implementation guidance in ASC 842-10-55-2 states that when assessing lease classification, a "reasonable approach" is to conclude that 90 percent or more of an asset's fair value represents "substantially all" of the asset's fair value. Accordingly, we believe that it would be reasonable for an entity to evaluate whether a capacity portion of an asset represents substantially all of that asset's capacity using a 90 percent threshold.

### *'Last mile' of contiguous asset*

In some contracts that involve a contiguous asset, such as an oil pipeline, a railroad, or an electrical transmission network, questions arise regarding whether a customer that has exclusive use of a portion of the contiguous asset is leasing that portion of the asset. For example, a customer whose terminal is located at one end of an oil pipeline might be the only customer using the pipeline segment between its terminal and the next customer's connection to the pipeline (the "last mile" of the pipeline). In these situations, the parties to the contract must determine whether the right to use that "last mile" segment is subject to the guidance in ASC 842.

According to ASC 842-10-15-16, a segment of a pipeline that connects a single customer to a larger pipeline is an example of a physically distinct capacity portion of an asset. We believe this example presumes that the pipeline segment is mechanically separable from the main pipeline, meaning that a valve could physically separate the segment's capacity from that of the main pipeline. Therefore, the "last mile" of a contiguous asset should be evaluated to determine whether it can be mechanically separated from the remainder of the contiguous asset. If mechanical separation is possible via a valve, switch, or similar mechanism, then the “last mile” of a contiguous asset would be an identified asset, similar to a pipeline lateral. Whether a contract that conveys the right to use that identified asset meets the definition of a lease depends on whether the customer or the supplier controls its use, as discussed in “Right to direct the use” under the next section below.

## Unit of account

The guidance in ASC 842 does not address how to determine whether a contract contains an identified asset when the right of use pertains to a non-capacity portion of an asset. For example, the owner of a cell tower enters into contracts to allow customers to install their electronic communication equipment on the tower, or the owner of a utility pole enters into contracts with media companies to affix data transmission wires to the utility pole. In scenarios like these, an entity should determine whether the identified asset is either the entire asset (for example, the cell tower or the utility pole) or just a portion of the asset that each customer uses (for example, the portion of the cell tower or utility pole where the customer has attached its equipment). This unit of account assessment is essential to determining whether the arrangement conveys to the customer both (a) the right to receive substantially all of the benefits from using the asset and (b) the right to direct the use of the asset.

Determining the identified asset in scenarios where the unit of account might be a portion of a larger asset requires judgment. In our view, an entity should consider the asset’s design in making this assessment. For example, an entity might determine that because a cell tower is designed to accommodate multiple customers’ electronic communication equipment, the attachment points are physically distinct portions of the asset, and the identified asset is the portion of the tower to which each customer’s equipment is attached. On the other hand, an entity might determine that because a utility pole is designed to suspend electrical transmission wires and is not specifically designed to allow multiple customers to attach their equipment, including data transmission wires, to separately identified locations on the pole, the attachment point for such equipment is not a physically distinct portion of the asset, and the identified asset is the entire utility pole.

As another example, an entity that obtains the right to display an advertisement directly on an exterior wall of a building must consider whether the identified asset in the contract is the entire building or the exterior wall. An entity might determine that the identified asset is the entire building rather than the exterior wall that is a component of the building, although the customer’s right of use pertains only to the exterior wall. In this example, the asset’s primary use (as residential or commercial space for tenants’ use) is different than the use contemplated in the contract (as a surface on which to display an advertisement), and therefore the exterior wall might not represent a physically distinct portion of the building. Accordingly, a contract that permits an entity to paint an advertisement on the side of a building might not contain a lease, because it does not allow that entity to control the use of the identified asset, which is the entire building.

In general, we do not believe that an entity should assess the components of a single integrated asset as separate lease components. This view is consistent with the following examples in ASC 842-10-55:

- Example 6, beginning at ASC 842-10-55-79, addresses a contract in which an entity agrees to transport a customer’s goods on a specified ship, and the identified asset is the ship rather than space on the ship.
- Example 7, beginning at ASC 842-10-55-92, addresses a contract in which an entity agrees to provide an aircraft for a customer’s use, and the identified asset is the aircraft rather than space on the aircraft.

- Example 9, beginning at ASC 842-10-55-108, addresses a contract in which an entity agrees to provide power generated by a solar farm to a customer. Although the solar farm consists of multiple pieces of equipment, including solar panels and electrical transmission equipment, the identified asset is the entire solar farm rather than its component parts.
- Example 10, beginning at ASC 842-10-55-124, addresses a contract in which an entity agrees to provide network services using identified servers. Although the servers consist of multiple components, such as processors and storage, the identified asset is each server rather than the components.

In most cases, we believe that the appropriate unit of account for purposes of determining whether a contract is or contains a lease can be determined by considering (1) the design of the asset, as illustrated in the cell tower and utility pole examples, and (2) the integrated nature of the asset, as illustrated in the examples from ASC 842-10-55 noted above.

The following table features several examples of how to determine the "identified asset" in arrangements where the unit of account is unclear or the customer's right of use is not related to the asset's primary purpose.

| Description | Identified asset | Commentary |
|---|---|---|
| Customer's right to attach equipment to utility pole | Utility pole | The space used by the customer is not physically distinct, and the customer's right of use is not equivalent to the asset's primary use, which is to suspend electrical transmission wires. |
| Customer's right to attach equipment to cell tower | Space on the cell tower | The space used by the customer is physically distinct, and the customer's right of use is equivalent to the asset's primary use, which is to accommodate multiple customers' electronic communication equipment. |
| Customer's right to display an advertisement on the side of a building | Building | The exterior wall used by the customer is not physically distinct, and the customer's right of use is not equivalent to the asset's primary use, which is to provide residential or commercial space for tenants' use. |
| Customer's right to display an advertisement on a billboard | Billboard | The billboard is a physically distinct asset, and the customer's right of use is |

| Description | Identified asset | Commentary |
|---|---|---|
| | | equivalent to the asset's primary use, which is to display an advertisement. |
| Customer's right to connect to the main pipeline via a pipeline lateral | Pipeline lateral | The lateral is a physically distinct asset. According to ASC 842-10-15-16, a segment of a pipeline that connects a single customer to the larger pipeline is an example of an identified asset. The customer's right of use is equivalent to the asset's primary use, which is to transport oil and gas. |
| Customer's right to connect to "last mile" of pipeline | Depends | If the "last mile" is mechanically separable from the rest of the pipeline, then it could be physically distinct. The customer's right of use is equivalent to the asset's primary use, which is to transport oil and gas. |

## Right to control the use of an identified asset

For a contract to contain a lease, it must convey to the customer the right to control the use of an identified asset. To control the use of an identified asset, the customer must have both the right to receive substantially all of the economic benefits from using the asset and the right to direct the use of the asset.

### Right to receive economic benefits

For a contract to meet the definition of a lease, it must provide the customer with the right to obtain substantially all of the economic benefits from using the asset throughout the period of use. The "period of use" is the period of time during which an asset is used to fulfill a contract with a customer, including nonconsecutive periods.

**FASB Accounting Standards Codification**

**Right to Obtain the Economic Benefits from the Use of the Identified Asset**

**ASC 842-10-15-17**

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

**ASC 842-10-15-18**

When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset in the contract (see paragraph 842-10-15-23). For example:

a. If a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory and not beyond.

b. If a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage and not beyond.

**ASC 842-10-15-19**

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if a customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. That is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

The economic benefits from using an asset include the asset's primary output and by-products. For example, the economic benefits from using a solar farm could include the power generated by the solar panels and renewable energy credits obtained through use of the assets to generate power.

Determining whether a customer has the right to obtain "substantially all" of the economic benefits from using the asset throughout the period of use can be challenging when an asset has multiple outputs that are sold to different customers.

**Example: Customer obtains less than 100 percent of economic benefits**

A specified wind farm has two types of output: power and renewable energy credits. Customer A enters into a 10-year contract to purchase all of the power generated by the wind farm. Due to a pre-existing arrangement, during the first three years of the contract Customer B has the right to obtain all of the renewable energy credits granted through use of the wind farm assets to generate power. For the remainder of the contract, Customer A has the right to all of the renewable energy credits granted.

The identified asset in the contract is the wind farm, and the period of use is equal to the 10-year term of the contract because that is the period during which the identified asset is used to fulfill the contract with Customer A.

To determine whether it has the right to receive substantially all of the economic benefits from using the identified asset during the period of use, Customer A compares the fair value of the outputs it obtains over the course of the period of use to the total fair value of the outputs generated during that period.

If, on average, the power generated by the wind farm represents 80 percent of the fair value of its output and the renewable energy credits represent the remaining 20 percent, then Customer A would have the right to obtain only 80 percent of the economic benefits from the use of the asset during the first three years of the contract. However, Customer A would have the right to obtain, on a fair value basis, approximately 94 percent of the economic benefits from using the asset over the course of the period of use.

ASC 842-10-55-2 states that when assessing lease classification, a “reasonable approach” is to conclude that 90 percent or more of an asset’s fair value represents “substantially all” of the asset’s fair value. Accordingly, in this case, since Customer A has the right to obtain more than 90 percent of the economic benefits from using the asset over the course of the period of use, it would be reasonable for Customer A to conclude that it has the right to obtain substantially all of the economic benefits from using the asset throughout the period of use.

An entity must evaluate the right to receive economic benefits from using an asset based on the defined scope of the customer’s rights according to the contract. For example, a customer that obtains the right to use a vehicle only within a certain territory specified in the contract could nevertheless have the right to obtain substantially all of the economic benefits from using that vehicle for the term of the contract. Although such restrictions might limit the economic benefits available from using an asset during the period of use, they do not prevent the customer from having the right to obtain all of the available benefits, considering contractual usage restrictions, during the period of use.

If a contract requires a customer to remit to a supplier a portion of the cash flows generated by operating the asset, such as a fixed percentage of revenue generated through the use of retail space, those cash flows would be considered part of the economic benefits obtained by the customer from operating the asset, which the customer then passes on to the supplier. Therefore, such a requirement would not preclude the customer from having the right to obtain substantially all of the benefits from operating the asset.

Similar to the example in the box above, assume that Customer A enters into a 10-year contract to purchase all of the power generated by a specified wind farm and to obtain all of the renewable energy credits granted through the use of the wind farm to generate power. Due to a previously existing arrangement between the owner of the wind farm and Customer B, Customer A must remit to the owner any proceeds obtained from selling renewable energy credits generated through use of the wind farm during the first three years of the contract, so that those proceeds can be distributed by the owner to Customer B.

The fact that Customer A must remit a portion of the cash flows generated from operating the asset does not preclude it from having the right to obtain substantially all of the economic benefits from operating the asset. Unlike the example in the box above, in which Customer B continues to obtain the renewable energy credits during the first three years of the contract, in this example Customer A is deemed to have the right to obtain 100 percent of the economic benefits from using the asset throughout the period of use.

### *Easements*

In general, the term “easement” refers to a right to access, traverse, or otherwise use certain property for a specific purpose. For example, a private landowner might grant an easement to a midstream oil and gas company to run a pipeline across a plot of land otherwise used for farming, or the U.S. government might grant an easement to a railroad operator to run railroad tracks across federally owned land.

The first step in analyzing a contract that conveys a long-term right to use land, such as a land easement, is to consider whether the contract conveys the right to use an identified asset for a period of time. Perpetual rights to use land do not meet the definition of a lease because they do not identify a period of time.

If a contract that conveys a long-term right to use land *does* specify a period of time, even if that period of time is exceptionally long (for example, 999 years), an entity must consider whether the contract conveys to the customer substantially all of the economic benefits from using the land for the term of the contract. The outcome of this analysis depends on the particular facts and circumstances of the arrangement.

For example, the potential economic benefits associated with using identified land in an otherwise unused area might be limited to, or substantially comprised of, benefits that are derived from running a pipeline over or under that land. In such circumstances, a pipeline company that enters into an easement might conclude that it has the right to substantially all of the economic benefits from using the land subject to that easement. On the other hand, the potential economic benefits associated with using farmland might consist of benefits from running a pipeline over or under the land, as well as the benefits from farming the land or having livestock graze on the land. In such circumstances, a pipeline company that enters into an easement might conclude that it does not have the right to substantially all of the economic benefits from using the land subject to that easement, depending on the relative value of the various outputs associated with using that land.

**Transition relief for easements**

In August 2017, the FASB tentatively decided to provide optional transition guidance for land easements not previously accounted for as leases under ASC 840, which allows entities to elect to continue accounting for these land easements under the guidance that the entity had previously been applying, such as ASC 350, *Intangibles – Goodwill and Other*.

The proposed transition relief relates to existing or expired land easements as of the effective date of ASC 842, but an entity needs to consider whether easements entered into after the effective date meet the definition of a lease.

## Right to direct the use

In addition to providing the customer with the right to receive substantially all of the economic benefits from using the asset, a lease must provide the customer with the right to direct the use of the asset throughout the period of use.

**FASB Accounting Standards Codification**

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

**ASC 842-10-15-20**

A customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:

a. The customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs 842-10-15-24 through 15-26).

b. The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:

    1. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.

    2. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

**ASC 842-10-15-21**

The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

A customer has the right to direct the use of the asset if either one of the following conditions is met:

- The customer has the right to direct how and for what purpose the asset is used.
- If the decisions about how and for what purpose the asset is used are predetermined, either
    - The customer has the right to operate the asset or to direct others to operate the asset in a manner it determines.
    - The customer designed the asset in a way that predetermines how and for what purpose it is used throughout the period of use.

To determine whether the customer has the right to direct the use of an asset, an entity must consider the rights to make decisions about the use of the asset only during the period of use. For example, if a customer's only decision-making right during the term of the contract is the right to specify, before the period of use begins, the output of certain equipment, and if the relevant decisions about how and for what purpose the asset is used are *not* predetermined, then the customer does not have the right to direct the use of the equipment. This is because the ability to specify the output before the period of use provides the customer with the same rights as any other customer that purchases goods or services. However, if the relevant decisions about how and for what purpose the asset is used *are* predetermined, then the customer must consider whether it has the right to operate the equipment or whether it designed the asset in a way that predetermines how and for what purpose it is used throughout the period of use.

### *Protective rights*

Contractual protective rights, such as specifying the maximum amount of use of an asset or limiting where the customer can use the asset, typically define the scope of the customer's right to use the asset, but do not, in and of themselves, prevent the customer from having the right to direct the use of the asset. For example, a limit on the number of miles that can be driven during the period of use in a car rental contract would not likely prevent the customer from having the right to direct the use of the automobile. Likewise, in a contract that conveys the right to use retail space in a shopping mall, limiting the hours of operation to times when the mall is open to the public would not likely prevent the customer from having the right to direct the use of the retail space.

### *How and for what purpose*

To have the right to direct how and for what purpose an asset is used throughout the period of use, a customer must have the contractual right to *change* how and for what purpose the asset is used throughout that period.

**FASB Accounting Standards Codification**

**How and for What Purpose an Asset Is Used**

**ASC 842-10-15-24**

A customer has the right to direct how and for what purpose an asset is used throughout the period of use if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout that period. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose an asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

**ASC 842-10-15-25**

Examples of decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose an asset is used, within the defined scope of the customer's right of use, include the following:

a. The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit)

b. The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)

c. The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)

d. The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

**ASC 842-10-15-26**

Examples of decision-making rights that do not grant the right to direct how and for what purpose an asset is used include rights that are limited to operating or maintaining the asset. Although rights such as those to operate or maintain an asset often are essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and often are dependent on the decisions about how and for what purpose the asset is used. Such rights (that is, to operate or maintain the asset) can be held by the customer or the supplier. The supplier often holds those rights to protect its investment in the asset. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-20(b)(1)).

To determine whether a customer has the right to change how and for what purpose an asset is used, an entity would consider decision-making rights that affect the economic benefits derived from using the asset.

Decision-making rights that provide the ability to direct how and for what purpose an asset is used include, but are not limited to, the right to change the type or quantity of output produced or to change when, where, or whether output is produced.

Rights that are limited to operating or maintaining an asset do not grant the right to direct how and for what purpose the asset is used, unless the relevant decisions about how and for what purpose an asset is used are predetermined. The Basis for Conclusions in ASU 2016-02 provides some insight into how to distinguish between rights to direct how and for what purpose an asset is used and rights to operate and maintain an asset.

**ASU 2016-02 Basis for Conclusions**

**BC137**

In the Board's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. That is because decisions about how and for what purpose an asset is used determine how and what economic benefits are derived from use. How and for what purpose an asset is used is a single concept; that is, "how" an asset is used is not assessed separately from "for what purpose" an asset is used. Decisions about operating an asset are generally about implementing the decisions about how and for what purpose an asset is used and are dependent on (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of an asset if the customer decides that the asset should not be used. The Board observed that considering decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of an entity. Decisions made by a board of directors about the

> operating and financing activities of an entity are generally the decisions that matter in that control assessment, rather than the actions of individuals in implementing those decisions.
>
> **BC138**
>
> Nonetheless, decisions about how and for what purpose an asset is used can be predetermined. In that case, those decisions cannot be made by either the customer or the supplier during the period of use. This could happen if, for example, in negotiating the contract, the customer and supplier agree on all the relevant decisions about how and for what purpose an asset is used and those decisions cannot be changed after the commencement date or are, in effect, predetermined by the design of the asset. The Board noted that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases.

In general, operational decisions are subordinate to decisions about how and for what purpose an asset is used, similar to how management's decisions about carrying out a business's operations are subordinate to decisions about operating and financing a business made by the board of directors in assessing how an entity is controlled.

In some cases, decisions about how and for what purpose an asset is used are predetermined under the contract. However, the Board expects that there will be "relatively few cases" where *all* of the decisions about how and for what purpose an asset is used are predetermined. Therefore, it is important for entities to focus on the decisions about how and for what purpose an asset is used that are available under the contract during the period of use. In cases where some decisions are predetermined, the conclusion about whether the customer has the right to direct the use of the asset depends on which party has the right to make decisions that are not predetermined about how and for what purpose the asset is used.

For example, a customer might enter into a contract for the right to use manufacturing equipment for a fixed period of time. According to the contract, the equipment located at the supplier's facility can produce only one type of output at a fixed quantity per hour. If the contract does not specify when the equipment must operate, then whichever party has the right to decide when or whether the equipment operates would likely have the right to direct how and for what purpose the equipment is used.

### *Application to portions of assets*

If a portion of an asset is determined to be physically distinct, an entity should carefully consider whether the customer has the right to direct how and for what purpose the asset is used throughout the period of use given that the identified asset is an integral component of the larger asset.

For example, a midstream oil and gas company constructs a pipeline lateral to connect its main pipeline system to a particular customer's facility. While it might appear that the customer has exclusive use of the lateral, it is important to consider whether the customer has the right to direct how and for what purpose the lateral is used throughout the period of use. In many cases the pipeline owner has the right to manage the capacity and pressure in the lateral as part of operating the pipeline system, which means that the customer whose facility is connected to the lateral probably lacks the right to direct how and for what purpose the lateral is used throughout the period of use.

It is also important to consider whether the lateral is mechanically separable from the main pipeline and, if so, which entity controls the separation. For example, if there is a valve where the lateral connects to the main pipeline and the customer controls whether that valve is open or closed, then the customer can decide to separately operate the lateral and would likely have the right to direct how and for what purpose the lateral is used. However, if the pipeline owner controls the valve, then the customer probably would not have the right to direct how and for what purpose the lateral is used. An entity's conclusion in a given scenario depends on the particular facts and circumstances.

## Lease identification challenges

Since a lease conveys substantially all of the economic benefits from using an identified asset to a customer, the first step in identifying a lease is to determine whether a customer has exclusive use of a specific asset, or otherwise obtains substantially all of the economic benefits from its use, for a period of time. Once this criterion has been met, it is necessary to determine whether the customer has the right to control the asset's use.

We have identified three broad categories of contracts in which the customer could have the right to control the use of an asset:

- The customer possesses the asset.
- The customer has the right to access the asset.
- The customer has the right to use the asset, although the customer can neither directly access nor possess the asset.

The first two categories include contracts that are typically identified as equipment and real estate leases, respectively.

In general, a customer is more likely to have the right to control an asset's use when the asset is in the customer's possession. A customer that physically possesses an identified asset is more likely to make decisions about the type of output produced, as well as about when, where, whether, and how much output is produced, by the identified asset.

When a contract involves the right to use real estate, the customer probably has significant decision-making rights under the contract as it acquires the right to access the real estate to conduct its own activities. For example, a retailer that obtains the right to use identified space in a shopping mall has the right to make decisions about the product mix, pricing, and other matters with respect to operating its retail business in that location.

### Right to use assets that the customer can neither access nor possess

The most challenging category to assess with respect to the definition of a lease is the third category, where a customer has the exclusive right to use an asset without possessing or being able to directly access it. This might be the case when a customer enters into a contract to obtain all the power generated by a specified power plant, or hires a vendor to provide network management services using specific remote servers.

If a customer neither possesses nor has the exclusive right to access an identified asset but has the exclusive right to use the asset, the customer is more likely to control an identified asset's use when it has "dispatch rights," which allow it to specify the timing and/or the quantity of output produced by the asset.

The following examples in ASC 842 illustrate how a customer's dispatch rights can impact whether a contract meets the definition of a lease.

**FASB Accounting Standards Codification**

**Case B—Contract Does Not Contain a Lease**

**ASC 842-10-55-112**

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer; Customer had no involvement in that design.

**ASC 842-10-55-113**

The contract does not contain a lease.

**ASC 842-10-55-114**

There is an identified asset because the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

**ASC 842-10-55-115**

Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year term of the contract.

**ASC 842-10-55-116**

However, Customer does not have the right to control the use of the power plant because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the plant is used. How and for what purpose the plant is used (that is, whether, when, and how much power the plant will produce) are predetermined in the contract. Customer has no right to change how and for what purpose the plant is used during the period of use, nor does it have any other decision-making rights about the use of the power plant during the period of use (for example, it does not operate the power plant) and did not design the plant. Supplier is the only party that can make decisions about the plant during the period of use by making the decisions about how the plant is operated and maintained. Customer has the same rights regarding the use of the plant as if it were one of many customers obtaining power from the plant.

**Case C—Contract Contains a Lease**

**ASC 842-10-55-117**

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (that is, Supplier cannot use the plant to fulfill other contracts).

**ASC 842-10-55-118**

Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate.

**ASC 842-10-55-119**

Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

**ASC 842-10-55-120**

The contract contains a lease. Customer has the right to use the power plant for 10 years.

**ASC 842-10-55-121**

There is an identified asset. The power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

**ASC 842-10-55-122**

Customer has the right to control the use of the power plant throughout the 10-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.

b. Customer has the right to direct the use of the power plant. Customer makes the relevant decisions about how and for what purpose the power plant is used because it has the right to determine whether, when, and how much power the plant will produce (that is, the timing and quantity, if any, of power produced) throughout the period of use. Because Supplier is prevented from using the power plant for another purpose, Customer's decision making about the timing and quantity of power produced, in effect, determines when and whether the plant produces output.

**ASC 842-10-55-123**

Although the operation and maintenance of the power plant are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the power plant is used. Consequently, Supplier does not control the use of the power plant during the period of use. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the power plant is used.

Ultimately, whether or not a contract contains a lease depends on the type of decision-making rights the contract provides to the customer.

## Assets used to obtain or utilize a good or service

Questions about whether a contract meets the definition of a lease often arise in arrangements where a customer obtains the right to use an asset in order to obtain or utilize a good or service from the supplier. For example, a medical testing company might provide its customer with testing equipment along with "consumables" (non-reusable products) that allow the customer to perform medical tests using that equipment.

In these situations, the customer should begin the lease analysis by determining whether it possesses the identified asset. If the customer does possess the asset, then it is more likely that the customer has the right to make the relevant decisions about how and for what purpose the asset is used. In the medical testing example, if the customer possesses the testing equipment, it could probably decide whether and when to perform the tests, the quantity of tests to be performed, and the location where the tests are performed. However, if the customer does not possess the testing equipment and sends the test samples to the supplier's lab to be analyzed using specified equipment designated for the customer's exclusive use, then the customer is less likely to decide when and where to perform the tests.

In some cases, the customer does not have the right to make the relevant decisions about how and for what purpose the asset is used, even though it possesses the identified asset. Example 10, Case A, in ASC 842-10-55 illustrates such a scenario.

**FASB Accounting Standards Codification**

**Example 10—Contract for Network Services**

**Case A—Contract Does Not Contain a Lease**

**ASC 842-10-55-124**

Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. To provide the services, Supplier installs and configures servers at Customer's premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

**ASC 842-10-55-125**

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

**ASC 842-10-55-126**

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

In Example 10, Case A, a customer enters into a contract to obtain network services from a supplier. To provide those network services, the supplier uses servers located at the customer's premises. From the customer's perspective, it has purchased network services, but since delivery of those services relies on specified assets, the customer must evaluate whether it is leasing those assets.

Based on our discussions with the FASB staff, there are three critical assessments in this example that lead to the conclusion that the contract is not a lease:

1. Identifying the assets
2. Identifying the output of the assets
3. Identifying the relevant decisions about how and for what purpose the assets are used to provide the output

Each of these criteria is examined below.

### *Identifying the assets*

This case does not explain whether the servers are explicitly identified in the contract, but, given that the servers are installed at the customer's premises, they are at least implicitly identified. The customer would be able to determine which particular servers are used by the supplier to provide the network services.

### *Identifying the output of the assets*

In this case, the output of each individual server is not equivalent to the network services being provided to the customer. The output must be determined for each identified asset, not for the group of identified assets. The supplier has the right to reconfigure the network so that each server can either perform a different function than it performed at the outset of the contract, or be taken offline for a period of time and not contribute at all to the network services. As a result, the output of each server is not predetermined and depends on what role the server is playing in the network at any point in time.

### *Identifying the relevant decisions about how and for what purpose the assets are used to provide the output*

Examples of decisions affecting how and for what purpose an asset is used include determining the type or quantity of output produced, as well as when, where, or whether output is produced.

With respect to each individual server, the decisions available under the contract include determining the type or quantity of output produced as well as when or whether output is produced, assuming that the supplier lacks the right to change the physical location of the servers. For example, the available decisions include

- Whether a server hosts a particular software package or stores customer data (type)
- How much data a server processes (quantity)
- Whether a server is available continuously or only runs at particular times (when)
- Whether a server performs a function in the network or is taken offline (whether)

The contract specifies the level of network services, but does not stipulate how those services will be provided using the identified assets. Decisions about how and for what purpose each server will be used in the performance of the network services are made by the supplier over the course of the contract. Since the customer does not have the right to make the relevant decisions about how and for what purpose the identified assets are used, the contract for network services is not, and does not contain, a lease.

As mentioned in the “Right to use assets that the customer can neither access nor possess” section, a key indicator that a contract conveys the right to direct the use of specified assets not in the customer’s possession is customer dispatch rights. In other words, if the customer can determine whether and when the identified assets are used to generate output, then it is more likely that the contract is or contains a lease. In Example 10, Case A, in ASC 842-10-55, the customer lacks dispatch rights with respect to the identified assets (each individual server). In other words, the customer cannot determine when or whether each server generates output, even though the server is located on the customer’s premises.

### Joint operating arrangements

In certain industries, such as oil and gas exploration, multiple entities enter into an arrangement to jointly undertake an activity, sometimes involving the formation of a separate legal entity. If completing the joint activity requires the use of leased equipment, such as a drilling rig, it is important to determine whether one of the entities participating in the arrangement—or the arrangement itself—is the customer from the equipment owner’s perspective. The customer must determine whether its contract with the equipment owner meets the definition of a lease.

In a joint arrangement that is not structured in a separate legal entity, it is common for one of the parties to the arrangement (the operator) to directly enter into a contract with the owner of an asset, and to use that asset to carry out the joint arrangement’s activities. In these scenarios, it is important for the operator to consider whether it is subleasing the asset to the joint arrangement, in which case, the operator must account for both the head lease with the asset owner and the sublease with the joint arrangement. Complicating the accounting for these arrangements is the fact that industry-specific guidance in U.S. GAAP could require proportionate consolidation of the joint arrangement by its participants. An operator that subleases an asset to a joint arrangement subject to proportionate consolidation would account only for the portion of the sublease related to the other joint arrangement participants.

## Next steps

As part of implementing ASC 842, companies not only need to gather information about existing leases, but also must consider whether they have identified all contracts that are or contain leases pursuant to the definition of a lease in the new standard. Companies should therefore develop a process for analyzing contracts under the new definition of a lease. Early in the ASC 842 implementation process, companies should identify contracts where there could be a lease under ASC 842, even though a lease was deemed not to previously exist, and apply their lease identification process to those contracts.

Examples of contracts that might contain leases include

- Long-term rights to use land (for example, easements)
- Multiple-element sales or purchase arrangements (for example, medical testing equipment and consumables)
- Service contracts that involve specified assets (for example, outsourced information technology services)
- Power purchase arrangements (for example, right to purchase all power from a solar farm)
- Right to use a physically distinct component of a larger asset (for example, pipeline lateral)

Once an entity has identified contracts that are or contain leases under the new standard, it can proceed to apply the recognition and measurement guidance, as well as the various practical expedients, in ASC 842 to those contracts.