No. 2016-17
19 May 2016

Technical Line

FASB — final guidance

How the FASB's new leases standard will affect oil and gas entities

In this issue:

Overview 1
Key considerations 3
Scope and scope exceptions ... 3
Definition of a lease 3
Identifying and separating components of a contract and allocating contract consideration 6
Lease classification 7
Lessee accounting..............8
Short-term leases recognition and measurement exemption 8
Lessor accounting 8
Other considerations 9
Joint operations 9
Lessee involvement in asset construction 9
Lease modifications 10
Sale and leaseback transactions.......................... 10
Related party lease transactions.......................... 10
Regulated operations 11
Appendix: Lessee accounting examples 12

What you need to know

- The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets. For oil and gas entity lessees, this may mean recognizing significant assets and liabilities for leases that have traditionally not been recorded on the balance sheet.
- Lessees and lessors will classify most leases using a principle that is generally consistent with current US GAAP but without the bright lines. Lease classification determines how lease-related expense and revenue is recognized as well as what lessors record on the balance sheet.
- Oil and gas entities will need to exercise judgment when applying the definition of a lease and allocating consideration between lease and non-lease components of contracts.
- For calendar-year public business entities, the guidance is effective in 2019 and interim periods within that year. For other calendar-year entities, it is effective in 2020 and interim periods in 2021. Early adoption is permitted for all entities.

Overview

Oil and gas entities will need to change certain lease accounting practices when implementing the new leases standard, Accounting Standards Codification (ASC) 842, *Leases*, issued by the Financial Accounting Standards Board (FASB or Board). ASC 842 significantly changes the accounting for leases and could have far-reaching implications for oil and gas entities' finances and operations. For example, applying the definition of a lease and allocating consideration between lease and non-lease components of contracts will require judgment.

EY

Building a better working world

ASC 842 requires lessees to recognize most leases on their balance sheets. For lessors, ASC 842 does not make fundamental changes to today's lessor accounting model. However, it modifies what qualifies as a sales-type and direct financing lease as well as the related accounting. For all entities, ASC 842 eliminates the real estate-specific provisions included in the current guidance (i.e., ASC 840*, Leases).*

Like ASC 840, ASC 842 requires lessees to classify most leases as either finance leases (generally capital leases under ASC 840) or operating leases. Lessors are required to classify all leases as either sales-type, direct financing or operating leases.

Leases are classified using a principle that is generally consistent with ASC 840 but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests). Lease classification determines how and when a lessee and a lessor recognize lease expense and income, respectively, and what assets a lessor records.

For lessees, the income statement recognition pattern for finance leases and operating leases is similar to that of today's capital leases and operating leases, respectively. That is, finance leases generally have a front-loaded expense recognition pattern, and operating lease expense is generally recognized on a straight-line basis.

For oil and gas lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications. Implementing the standard could be a lengthy process and require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease, (2) initially and subsequently measuring lease-related assets and liabilities, (3) identifying and allocating consideration to lease and non-lease components and (4) collecting and aggregating information necessary for disclosure.

ASC 842 is effective for public business entities (PBE) for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period presented in the financial statements. For example, for a calendar-year PBE that presents three years of financial statements, the effective date will be 1 January 2019 and the transition provisions must be applied beginning 1 January 2017. Full retrospective application is prohibited.

This publication summarizes the new standard and describes some industry-specific issues you may want to start working on. Like all other entities, you'll also need to apply the new standard to leases of office space, office equipment and all other leased assets.

This publication is intended to complement our Technical Line, *A closer look at the new leases standard* (SCORE No. 00242-161US), which provides an in-depth discussion of ASC 842. We refer to that publication as our general Technical Line. Oilfield service entities involved in engineering and construction activities should also read our Technical Line, *How the FASB's new leases standard will affect engineering and construction entities* (SCORE No. 00525-161US).

The views we express in this publication are preliminary as of May 19, 2016. We may identify additional issues as we analyze ASC 842 and entities begin to interpret it, and our views may evolve during that process.

Key considerations

Scope and scope exceptions

Consistent with ASC 840, the scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those natural resources and rights to use the land in which those natural resources are contained
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

Leases of oil and gas mineral rights or drilling rights are outside the scope of ASC 842 and will continue to be accounted for under the guidance in ASC 932, *Extractive Activities — Oil and Gas*. That includes the right to use the land that contains the mineral resources, unless those rights include more than the right to explore for natural resources. The scope exception does not apply to leases of equipment that is used to explore for oil and gas.[1]

Entities will apply the leases standard to determine whether contracts that transfer the right to use an asset within the scope of ASC 842 contain a lease.

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.

Identified asset

The concept of an identified asset is generally consistent with the "specified asset" concept in ASC 840. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from the exercise of its right to substitute the asset.

In some cases, determining whether there is an identified asset is relatively straightforward. For example, many contracts involving oil and gas retail operations have identified assets such as the land or buildings for a gasoline station. In other circumstances, determining whether there is an identified asset may require judgment. This may be the case for arrangements for the following:

- Storage in tanks or caverns
- Drilling by an oilfield service entity
- Transportation using dedicated capacity of a pipeline, rail car or other vessel

Among other considerations, entities will need to carefully evaluate whether any substitution right that the supplier retains is substantive. For example, the supplier's substitution rights may not be substantive if (1) the asset is highly customized, (2) alternative assets are not readily available or (3) it is unclear that the supplier would economically benefit from the exercise of the right.

Some oil and gas transportation contracts involve a dedicated pipeline segment that is part of a larger pipeline (e.g., a transportation contract that includes a dedicated connection between two locations). The pipeline segment may not be explicitly identified in the contract. However, ASC 842 clarifies that a segment of a pipeline that connects a single customer to the larger pipeline would be an identified asset.[2] An entity will need to evaluate whether a well connection or other dedicated pipeline that connects to a larger pipeline system is an identified asset, even if the larger pipeline system serves other customers.

Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

Evaluating whether the customer has the right to direct the use of an identified asset will require judgment.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

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

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) 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.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.[3]

ASC 842 provides examples of the decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose the asset is used, within the defined scope of the customer's right of use. Examples include the rights to change (1) the type of output that the underlying asset produces, (2) when the output is produced, (3) where the output is produced and (4) whether the output is produced and the quantity of the output.

Evaluating whether the customer directs the use of an identified asset will be straightforward in most arrangements. However, evaluating other arrangements — particularly those with a significant service component, such as drilling and transportation contracts — may require more judgment. For example, when a drilling contract requires the supplier to provide and operate a drilling rig for a customer, the customer would direct the use of the asset if it makes the decisions that most significantly affect the economic benefits derived from the rig throughout the period of use even though it does not physically operate the rig. The supplier may retain certain rights, such as the rights to operate the drilling rig and to make certain decisions to protect its investment in the asset (e.g., determining whether conditions are safe for operation). However, these types of supplier decisions would be considered protective rights, which, in isolation, are not the decisions that most significantly affect the economic benefits derived from the drilling rig throughout the period of use.

Under the definition of a lease in ASC 840, a customer's right to obtain substantially all of the output of an asset (e.g., a natural gas processing facility) often results in the arrangement including a lease (assuming other criteria are met). ASC 842, however, focuses on control of the identified asset. That is, for the arrangement to contain a lease, a customer must (1) obtain substantially all of the economic benefits (e.g., output) of an asset and (2) direct the use of the asset. Upstream and midstream entities with natural gas processing contracts that use all or substantially all of the capacity of a processing facility will need to evaluate whether they have the ability to direct the use of the facility. Oil and gas entities also may need to consider similar factors when they determine whether the customer directs the use of dedicated portions of gathering lines (e.g., well connections) or pipeline segments, since the customer may determine when or whether the pipeline segment is used to transport hydrocarbons, subject to system safety constraints.

ASC 842's transition guidance is discussed in the general Technical Line. As part of a package of consistently applied practical expedients for transition, entities can make an accounting policy election to apply their existing lease identification and classification conclusions (i.e., those properly made based on ASC 840's definition of a lease and classification criteria) for certain contracts.

How we see it

Because ASC 840's accounting for operating leases and service contracts is similar, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under ASC 840 because, under ASC 842, most operating leases are recognized on lessees' balance sheets, and the effects of accounting for an arrangement as a service instead of a lease may be material. The FASB noted in the Basis for Conclusions (BC 393 (a)) that the practical expedient that permits entities not to reassess whether any expired or existing contracts contain leases does not grandfather incorrect assessments made under ASC 840 (i.e., the practical expedient applies only to arrangements that were appropriately assessed under ASC 840).

Identifying and separating components of a contract and allocating contract consideration

For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of these conditions are met: (1) the lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee, and (2) the right of use is neither dependent on, nor highly interrelated with, the other right(s) to use the underlying assets in the contract. However, for contracts that involve the right to use land and other assets (e.g., land and a service station), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, even if the criteria above for separating lease components are not met, unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components).For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other US GAAP. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, *Revenue from Contracts with Customers*, by lessors (suppliers). ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Many oil and gas contracts contain a lease and a non-lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

Oil and gas contracts that may contain a lease also may contain non-lease components for services provided by the supplier. Examples may include:

- Drilling arrangements, which typically include services such as operating the rig
- Storage and transportation arrangements, which generally require the supplier to operate the facilities or pipelines
- Gathering agreements, which may include dedicated well connections that qualify as leases as well as larger pipeline segments that do not qualify as leases

Lessees that don’t elect the practical expedient to account for lease and non-lease components as a single lease component will have to allocate the consideration in the contract to the lease and non-lease components. These allocations may be difficult for some entities because the relative standalone prices for some services are not readily available. For example, if an entity determines that a deepwater drilling contract contains a lease, estimating standalone prices for the lease and non-lease components may be challenging if there is no available market data for each component.

When contracts involve up-front costs (such as initial mobilization costs or well connection cost reimbursements), both lessees and lessors will need to determine how to allocate those costs to the lease and non-lease components.

How we see it

- Identifying non-lease components of contracts may change practice for some lessees in the oil and gas industry. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognized on lessees' balance sheets under ASC 842, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.
- Lessors may need to develop more robust processes to evaluate how to allocate and account for variable payment amounts between lease and non-lease components.

Lease classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets any of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the "substantially all" criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors are required to reassess lease classification upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that does not result in a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

Some oil and gas entities, particularly those with midstream and downstream activities, currently consider the existing real estate-specific guidance for leases of integral equipment or in-substance real estate to determine lease classification. The new standard eliminates the real estate-specific lease guidance. Instead, entities follow the same classification guidance for leases of all assets.

Lessee accounting

At the commencement date of a lease, a lessee recognizes a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability is the same for finance leases and operating leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for finance leases and operating leases differs under ASC 842. For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of capital leases under ASC 840. The periodic lease expense for operating leases is generally recognized on a straight-line basis, similar to the accounting for operating leases under ASC 840.

The new standard eliminates the real estate-specific lease guidance.

As they do today, lessees will continue to capitalize the portion of lease costs that are part of the cost to acquire or construct another asset, such as lease costs associated with equipment that is used to develop oil and gas properties.

Refer to the appendix for examples of lessee accounting for a finance lease and an operating lease.

Short-term leases recognition and measurement exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise (short-term leases). If an entity applies this exception, short-term leases are not recognized on the balance sheet and the related lease expense is recognized on a straight-line basis over the lease term.

Lessor accounting

Oil and gas entities that provide services that involve identified assets (e.g., storage, transportation or drilling services) might be considered lessors, depending on the terms of the arrangements.

ASC 842 requires lessors to account for sales-type leases using an approach that is similar to ASC 840's sales-type lease accounting. That is, lessors derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize, in net income, any selling profit or selling loss.[4] However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease.

Instead, a lessor continues to account for the underlying asset using other US GAAP and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either (1) the contract is terminated, and the lease payments received from the lessor are nonrefundable, or (2) the lessor repossesses the underlying asset and has no further obligation to the lessee under the contract and the lease payments received from the lessee are nonrefundable.

Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

Under ASC 842, lessors account for operating leases in a manner similar to how they account for operating leases under ASC 840. That is, lessors continue to recognize the underlying asset, and lease payments for which collectibility is probable at lease commencement are recognized over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

Leveraged lease accounting is eliminated for new leases and existing leases modified on or after the standard's effective date. That is, lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classifications discussed above. However, leveraged leases that exist before the effective date are grandfathered.

Other considerations

Joint operations

In a joint operation or similar arrangements, an operator of an oil and gas property may agree with other parties (e.g., non-operators) to perform certain activities necessary to develop the property and produce oil and gas. To fulfill its responsibilities, the operator may arrange or be a counterparty to service or rental agreements that may contain leases. Such agreements will have to be evaluated carefully by the counterparty to each contract (e.g., the operator, joint operation) to determine if it controls the use an identified asset throughout the period of use.

Lessee involvement in asset construction

Oil and gas entities with retail operations frequently consider "build-to-suit" guidance when they participate in the construction of a new retail site (e.g., gasoline station) that they will lease from another entity upon completion.

ASC 842 makes significant changes to how a lessee would evaluate whether their involvement in asset construction subjects their lease to sale and leaseback accounting. While ASC 840 focuses on whether the lessee has substantially all of the construction-period risk to determine if it is the accounting owner of an asset under construction, ASC 842 changes the focus to whether the lessee controls the asset being constructed.

If the lessee controls the asset during the construction period, an entity will apply the sale and leaseback guidance when the construction of the asset is complete and the lease commences. If the lessee does not control the underlying asset being constructed, any payments made for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments. Lease payments made prior to lease commencement are recognized as a prepaid asset and evaluated in the lease classification test. Costs incurred by the lessee (when the lessee does not control the asset during construction) that relate specifically to construction or design of an asset that are not payments for the use of an asset to be leased are recognized in accordance with other US GAAP (e.g., ASC 330 *Inventory*, ASC 360, *Property*, *Plant, and Equipment*).

For guidance on accounting on lessee involvement in construction and related transition guidance refer to our general Technical Line.

Lease modifications

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. These may occur in the oil and gas industry, for example, when entities modify a storage or transportation contract to expand the leased capacity. At other times, entities may terminate a portion of a contract, such as a reduction in the scope or timing of a drilling contract.

Entities will account for a lease modification as a separate lease (i.e., separate from the original lease) when certain conditions are met.

In a change from today's guidance, lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original lease) when certain conditions are met. How an entity will account for modifications that do not result in a separate contract will depend on whether the entity is a lessee or lessor, the nature of the modification and the classification of the lease before and after the modification.

Refer to our general Technical Line for further details on accounting for lease modifications.

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

ASC 842 requires seller-lessees and buyer-lessors to consider the new revenue recognition standard and other criteria in ASC 842 (e.g., a sale with a finance leaseback would not qualify as a sale) to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

Related party lease transactions

ASC 842 requires lessees and lessors to account for related party leases (e.g., leases of assets such as pipelines or storage tanks between an entity and a related master limited partnership or equity method investee) on the basis of the legally enforceable terms and conditions of the lease. This eliminates the current requirement under US GAAP for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting.

Lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with ASC 850, *Related Party Disclosures*.

Regulated operations

Entities subject to rate regulation should first apply ASC 842 and then consider whether differences from regulatory accounting may affect the recognition and subsequent measurement of regulatory assets and liabilities under ASC 980, *Regulated Operations*.

Next steps

- Because of the number and magnitude of contracts they will need to evaluate and potentially recognize on their balance sheets, oil and gas entities should start to accumulate information that will be necessary to evaluate agreements that may contain lease components, particularly drilling contracts, transportation or capacity arrangements, storage agreements and downstream retail land, building and equipment rental contracts.
- Entities should then determine how their lease accounting will be affected. Two critical first steps include (1) identifying the sources and locations of an entity's lease data and (2) accumulating that data in a way that will facilitate the application of ASC 842. For entities with decentralized operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility of differences in operational, economic and legal environments. Entities will also need to make sure they have processes (including internal controls) and systems in place to collect the necessary information to implement ASC 842.
- Entities also may want to monitor the discussions of the Board and others including the Securities and Exchange Commission (SEC) staff as they consider interpretations and the application of ASC 842 to common transactions.

Endnotes:

[1] ASC 842-10-15-1.

[2] ASC 842-10-15-16.

[3] ASC 842-10-15-5.

[4] At the commencement date, selling profit or loss is calculated as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset net of any unguaranteed residual asset.

[5] ASC 842-10-15-4.

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 01084-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

Appendix: Lessee accounting examples

Illustration 1 — Lessee accounting for an operating lease

Downstream Co. (Lessee) enters into a three-year lease of a storage tank and concludes that the agreement is an operating lease. Downstream Co. agrees to pay the following annual payments (in thousands) at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Downstream Co. uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Downstream Co. calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement Downstream Co. would recognize the right-of-use asset and lease liability (in thousands) that it wouldn't recognize today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Right-of-use asset		$ 2,000
Cash		$ 10,000
Lease liability	$ 8,602	
Right-of-use asset		$ 8,602

To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of year one.

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows (in thousands):

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 2 — Lessee accounting for a finance lease

Upstream Co. (Lessee) enters into a three-year lease of equipment and concludes that the agreement is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). Upstream Co. agrees to make the following annual payments (in thousands) at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Upstream Co. uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Upstream Co. amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Upstream Co. would recognize the right-of-use asset and lease liability (in thousands) in a manner similar to what it would do today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Lease liability		$ 1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$ 10,000	
Cash		$ 10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows (in thousands):

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 3 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the finance lease (see Illustration 2) and the operating lease (see Illustration 1):

Finance lease (in thousands):

Time	Lease liability	Right-of-use (ROU) asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Operating lease (in thousands):

Time	Lease liability	Cumulative prepaid (accrued) rent[1]	ROU asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

[1] Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement but with different income statement classification and timing of recognition. However, a lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease.