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Technical Line

FASB — final guidance

How the FASB's new leases standard will affect power and utilities entities

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What you need to know

- The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets. For power and utilities lessees, this may mean recognizing assets and liabilities for most leases that they may currently account for as operating leases.
- 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.
- Power and utilities entities will need to exercise judgment when applying the definition of a lease to arrangements such as power purchase agreements.
- 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

Power and utilities (P&U) 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 P&U entities' finances and operations. For example, P&U entities will need to exercise judgment when applying the definition of a lease to arrangements such as power purchase agreements.

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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 P&U lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications. Implementing the standard could 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.

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

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. 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 can be relatively straightforward. However, in other cases this assessment will require judgment. For example, a capacity portion of an asset that is not physically distinct (e.g., a capacity portion of a power plant) is not an identified asset unless it represents substantially all of the capacity of a physically distinct asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

In addition to specifying a physically distinct asset, entities also need to determine if a supplier has a substantive substitution right. For example, a customer should consider if an energy supplier's substitution right could be substantive if the supplier has the practical ability to substitute the energy source (e.g., it has readily available alternative sources to provide power) and would benefit from doing so throughout the period of use. However, contract terms that provide protective rights or other rights that allow or require substitution only when the underlying asset is not operating properly would not create a substantive substitution right. In addition, if a customer cannot determine whether the supplier has a substantive substitution right, the customer would presume it is non-substantive.

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

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.

Requiring a customer to have the right to direct the use of an identified asset is a change from ASC 840. A contract may meet ASC 840's control criterion if, for example, the customer obtains substantially all of the output of an underlying asset and meets certain price per unit of output criteria. Under ASC 842, these arrangements would no longer be considered leases unless the customer also has the right to direct how and for what purpose the asset is used throughout the period of use. For example, the customer's right to determine whether to produce power from a power plant and how much may indicate that it has the right to control the use of the power plant.

When evaluating whether the customer has the right to obtain substantially all of the economic benefits from the use of an identified asset, entities need to evaluate the asset's primary outputs (e.g., electricity) and any byproducts (e.g., renewable energy credits). For example, an entity that purchases all of the electricity generated by a solar plant may not have the right to obtain substantially all of the economic benefits from the use of the identified asset if the plant

also generates renewable energy credits, generated through operations, that provide a third party with economic benefits (i.e., economic benefits sufficient to determine that the entity does not obtain substantially all of the economic benefits).

If the most relevant decisions about how and for what purpose the asset is used are predetermined before the period of use, entities will need to evaluate which party has the right to direct the use of the asset by evaluating whether the customer either:

- 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 those operating instructions
- 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

Example 9 in ASC 842 illustrates an entity determining whether a contract contains a lease.

Renewable energy credits that are generated through operation are considered when evaluating whether an entity obtains substantially all of the economic benefits from the use of an asset.

Illustration 1 — Identifying a Lease

Example 9 — Contract for Energy/Power

Case A — Contract Contains a Lease

842-10-55-108 A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

842-10-55-109 The contract contains a lease. Customer has the right to use the solar farm for 20 years.

842-10-55-110 There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.

842-10-55-111 Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.

b. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm (as described in paragraph 842-10-15-20(b)(2)). Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

Case B — Contract Does Not Contain a Lease

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.

842-10-55-113 The contract does not contain a lease.

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.

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.

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

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).

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.

842-10-55-119 Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

842-10-55-120 The contract contains a lease. Customer has the right to use the power plant for 10 years.

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.

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.

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.

Under ASC 842, determining whether certain contracts, particularly those involving a significant service component (e.g., contracts for energy generation), contain a lease is important for lessees because lessees are now required to account for most leases on their balance sheet.

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 based on ASC 840's definition of a lease and classification criteria) for existing or expired contracts.

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 solar panel arrangement and a power conversion building), 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 generation facilities), 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.

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.

Under ASC 840, lease-related executory costs (e.g., the cost of maintaining the underlying asset) are considered part of the lease component. Under ASC 842, payments for maintenance activities are considered non-lease components. P&U lessees that don’t elect the practical expedient to account for lease and non-lease components as a single component will need to evaluate leases for any non-lease components (e.g., operations and maintenance services, fuel arrangements, ancillary services) and allocate the consideration in the contract to those components.

How we see it

Identifying non-lease components of contracts (e.g., operations and maintenance services, fuel arrangements, ancillary services) may change practice for some lessees in the P&U 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.

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.

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

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.

P&U entities currently consider the real estate-specific guidance for leases of integral equipment or in-substance real estate, such as power plants, to determine lease classification. For example, the real estate-specific guidance currently requires the lessor to transfer title to the lessee prior to the end of the lease term in order for a lease of real estate to be classified as a sales-type lease. 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.

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

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.[1] 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.

Other considerations

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.

Regulated operations

Entities subject to rate regulation should consider how the application of ASC 842 could affect the recognition and subsequent measurement of regulatory assets and liabilities under ASC 980, *Regulated Operations*.

Next steps

- Entities should perform a preliminary assessment as soon as possible to 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.

Endnote:

[1] 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.

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Appendix: Lessee accounting examples

Illustration 1 — Lessee accounting for an operating lease

Utility B (Lessee) enters into a three-year lease power purchase agreement for a gas-fired plant with a remaining life of 25 years and concludes that the agreement is an operating lease. Utility B agrees to pay the following annual payments 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%. Utility B uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Utility B calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

***Analysis*:** At lease commencement Utility B would recognize the right-of-use asset and lease liability 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 1.

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

	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

Utility A (Lessee) enters into a three-year power purchase agreement for all of the electricity generated by a coal-fired power plant 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). Utility A agrees to make the following annual payments 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%). Utility A uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Utility A amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Utility A would recognize the right-of-use asset and lease liability 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:

	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:

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:

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.