JO Knows the Overview of Identifying a Lease

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With the implementation of the new lease accounting standard upon us (Accounting Standards Codification 842, *Leases* (ASC 842)), and the impact that this new standard could potentially have on the financial statements for so many entities, we have so far focused on providing entities with a high level understanding of the new lease standard. We would like to now hone in on the details of implementing the standard. Over the next several months we will provide a series of email blasts that takes you through the steps of implementing the lease standard. So, where do you begin?

The first step in applying ASC 842 is to understand the definition of a lease and then to determine whether contracts contain a lease under ASC 842. A lease is defined as a contract, that conveys **the right to control** the use of **identified property, plant, or equipmen**t (an identified asset) for a period of time in exchange for consideration. A contract may be a lease itself, or another agreement that contains a lease.

There are several terms that require a deeper dive in order to really understand the context of this definition.

Does an Identified Asset Exist?

Let's start with whether an asset is specified in the agreement. Identification of an asset is generally analyzed by looking for an asset explicitly in a contract. However, at times, an asset may not be explicitly identified, but rather implicitly identified.

Agreements for the use of a portion of an asset is an identified asset if it is physically distinct (i.e., floor of a building). Agreements for a portion of an asset's capacity which is not physically distinct (i.e., 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 of the asset.

Another factor to consider is whether the supplier has a substantive right to substitute a different asset for the identified asset throughout the period of use. Substitution rights would be considered substantive if the supplier has the practical ability to substitute alternate assets and would benefit economically from doing so. The existence of substantive substitution rights calls into question whether there is an identified asset in the agreement.

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.

Does the Agreement Convey the Right to Control?

The second attribute to consider in the definition of a lease is whether the contract conveys the right to control the use of the identified asset? In order for a customer to have control it must have both:

- The right to obtain substantially all of the economic benefits from the use of the asset, and
- The right to direct the use of the asset.

When assessing the right to obtain substantially all of the economic benefits from the use of an asset, a customer must 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. For example, if a contract limits the use of a motor vehicle to only one particular territory during the period of use, the customer must consider only the economic benefits from use of the motor vehicle within that territory, not beyond.

The right to direct the use of the asset is demonstrated when the customer has the right to direct how and for what purpose the asset is used throughout the period of use. In making this assessment, a customer 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. Examples of decision-making rights include the rights to change:

- the type of output that is produced by the asset
- when the output is produced
- where the output is produced
- whether the output is produced and the quantity of that output

Conversely, an agreement may contain protective rights – those meant to protect the supplier's interest in their asset from misuse. The existence of protective rights would not preclude a customer from determining that they can direct the use of the asset.

Conclusion

Implementing the new lease standard may be a challenging process but one that can be made easier by understanding and following the key components in the definition of a lease when analyzing contracts to determine if a lease under ASC 842 exists. When reviewing the contract consider the following questions:

- Is an asset specifically identified in the contract?
- Does the supplier have substantive substitution rights?
- Does the customer have the right to substantially all of the economic benefits from the use of the asset?
- Does the customer have the right to direct the use of the asset?

Based on the answers to these questions you should be able to accurately apply the new lease standard.

Effective Date

ASC 842 is effective for private companies and nonprofit organizations with annual reporting periods beginning after December 15, 2021 and interim periods within fiscal years starting after December 15, 2022.

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