Embedded Components in Lease and **Non-Lease Arrangements**

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CURRICULUM: Accounting and Auditing

LEVEL: Intermediate

DESIGNED FOR: CPAs in industry and public practice

OBJECTIVES: To provide an analytical review of embedded transactions in lease and non-lease arrangements and a general framework that CPAs can reference to research the complexity of the issues involved in an emblematical lease transaction

KEY TOPICS: Latest guidance from the Financial Accounting Standards Board; multiple arrangements as a single contract; related party arrangements; embedded derivatives; lease, non-lease and not contract components; and lessor and lessee accounting

PREREQUISITES: None

ADVANCED PREPARATION: None

This article provides an analytical review of embedded transactions in lease and non-lease arrangements based on ASC 842, *Leases*; ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors;* and ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. There is significant management judgment involved to identify lease and non-lease components of an arrangement, and lessees and lessors may need to probe the nature of an arrangement and often rely on other standards to properly account for them.

Latest Guidance

In July 2018, the Financial Accounting Standards Board (FASB) issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, that provides guidance for separating lease and non-lease components in a contract and allocates the contract consideration into separate components. This ASU provides companies with an additional (and optional) practical expedient transition method to adopt the new lease standard.

In December 2018, FASB issued ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, that requires lessors to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased or whether the lessors have collected those taxes from the lessees on behalf of third parties. This ASU provides entities with an additional (and optional) practical expedient transition method to adopt the new leases standard.

Embedded Leases

In lease arrangements, one party obtains the right to use an asset legally owned by another party for a period of time. Lease contracts often create a "Right of Use" (ROU) for the lessee that distinguish them from other contracts. However, the right to control the use of an asset may not be necessarily evident in a contract. An embedded lease in a non-lease transaction may have an *ipso facto* claim to be a lease within the scope of ASC 842.

Multiple Arrangements

FASB requires that companies consider multiple arrangements as a single contract for the purpose of identifying embedded leases. Therefore, companies need to expand the scope of their reviews and include any additional contracts that a company has entered into simultaneously or within a short span of time with the lease arrangement to identify any embedded leases (e.g., a service arrangement may contain both lease and non-lease components).

ASC 842 accounting for embedded leases is as follows:

- Lessee classifies the embedded lease component as an operating or finance lease and reflects the ROU and the corresponding lease liability on its balance sheet.
- Lessor classifies the embedded lease component as a sales-type, direct financing or operating lease.

ASC 842-10-25-19 specifies the following criteria to consider in making this determination:

An entity shall combine two or more contracts, at least one of which is or contains a lease, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:

a. The contracts are negotiated as a package with the same commercial objective(s).

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15- 28.

Related Party Arrangements

Related parties need to analyze an agreement for its legally enforceable rights to determine if an embedded lease exists. ASC 842-10-55-12 requires that companies perform such analyzes as if the contract was between unrelated parties:

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

Embedded Derivatives in Lease Arrangements

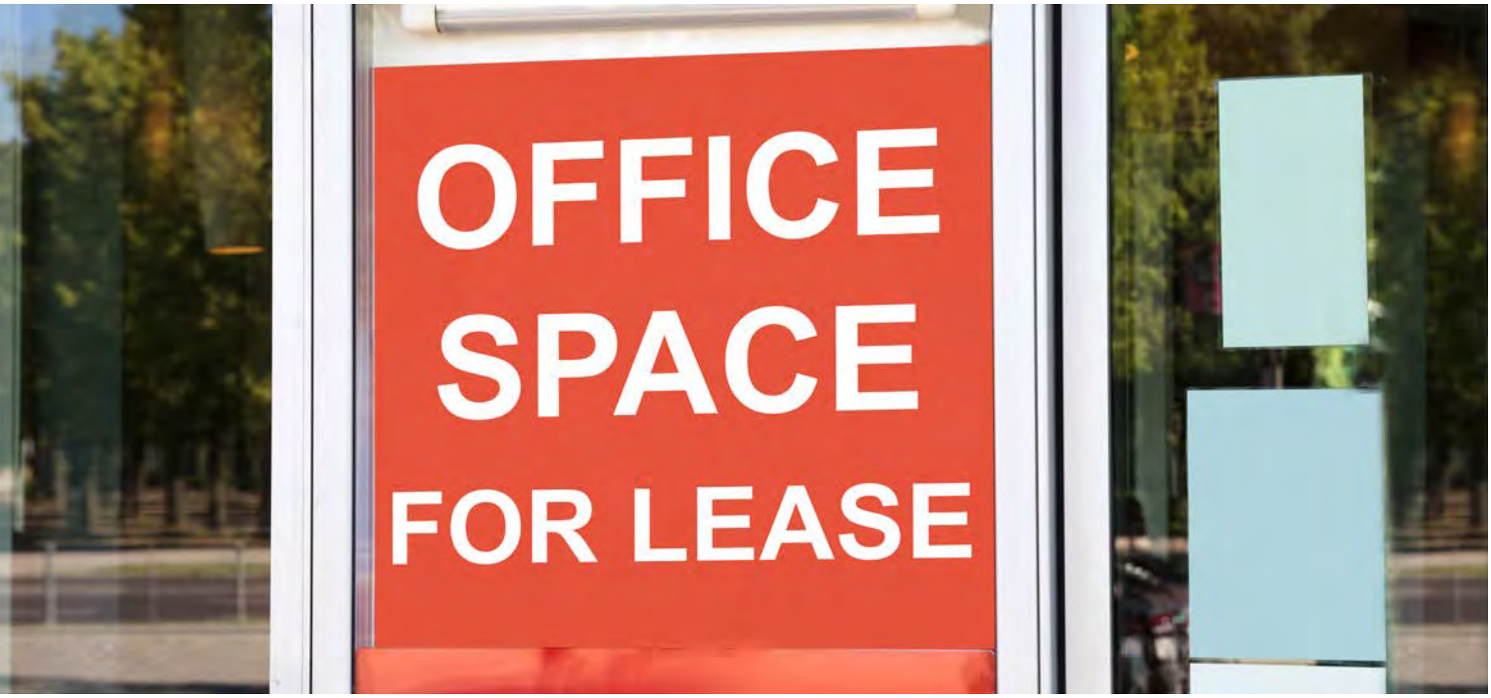
There may be other transactions embedded in a lease arrangement that may need to be priced or bifurcated and accounted for separately. ASC 815, *Derivatives and Hedging*, excludes leases from its scope, but nevertheless lease arrangements may contain embedded derivatives. If so, companies may need to bifurcate and account for them based on ASC 815 (ASC 815-10-15-79).

For example, a residual value guarantee grants holder a put right, which can potentially be an embedded derivative. ASC 815-10-15-80 excludes residual value guarantees that are subject to the requirement of Topic 840 from the scope of Topic 815, but ASC 815-10-15-81, on the other hand, includes residual value guarantees that has a third-party residual value guarantor within the scope of Topic 815. As a result, lessors must determine whether such residual guarantees are derivative instruments and if they qualify for any scope exception under Topic 815.

If a lease arrangement contains an embedded derivative, the embedded derivative should be separated from its host contract if the following two conditions exist:

- It is not "clearly and closely related" to its host contract pursuant to ASC 815-15-30.
- ASC 815 would consider it a derivative if it were a separate instrument.

FASB requires an analysis of both quantitative and qualitative considerations to arrive at "clearly and closely related" criterion (ASC 815-15-31). If the embedded derivative is not "clearly and closely related" to the lease agreement, it must be bifurcated and accounted for separately from the contract (possibly as a derivative under ASC 815).



The following examples illustrate partial application of a "clearly and closely related" criterion:

- FASB considers inflation-indexed lease arrangements that vary based on increases in CPI (customer price index) or PCE (personal-consumption expenditures) as "clearly and closely related." Thus, no bifurcation is required unless there are additional factors involved (e.g., rent payments escalate at a much faster rate than the inflation index).
- FASB does not require any bifurcation for lease arrangements with variable lease payments based on the sales volume. (ASC 815-10-15-59 has an exception for non-exchange-traded contracts.)
- Similarly, FASB does not require any bifurcation for lease arrangements with lease payments based on variable interest rates.

The following examples partially illustrate the situations that the elements of a lease arrangement are not "clearly and closely related:"

- Leveraged inflation indexes that are, for example, two times greater than CPI (ASC 815-15-25 (Q&A 31)).
- Inflation index adjustments that are different from the indexes in the environment that the company is operating in (e.g., a U.S.-based company with operations based solely in the U.S. uses Venezuelan inflation rate).
- Certain lease payables in foreign currency (a currency other than the company's functional currency) (ASC 815-15-25 (Q&A 02)).

The following is a partial list of potentially embedded derivatives:

- Option arrangements for purchase or repurchase of a lease item or options for renewal of lease arrangements.
- Certain indexed rental payments.
- Additional payments contingent on the occurrence of certain outside events or achieving a certain outside threshold.
- Rental payments dominated in a foreign currency.

Companies must analyze the terms of any lease arrangement that contains the above and similar provisions to determine whether they meet the definition of a derivative under ASC 815-10-15-83 and, if so, FASB requires that companies follow Topic 815 accounting.

Lease Components, Non-Lease Components and Not Contract Components

Lease components are elements of arrangement that provide lessees with ROU of leased assets, whereas non-lease components do not provide lessees with any ROU. For example, if the lessor of a real estate property provides landscaping services for the property that it leases, the arrangement has two components: the lease component that provides ROU to the lessee and the non-lease component for landscaping services that lessee subsequently reimburses the amount to the lessor (ASC 842-10-15-30).

FASB requires companies to account for the non-lease components of their lease contracts under their relevant applicable standards. Therefore, lease arrangements may contain payments for lease components, non-lease components and items that are not considered contract components:

- Lease components are elements of the arrangement that provide the customer with the right to use an asset (e.g., lease of equipment or real estate).
- Non-lease components are distinct elements of an arrangement that are not related to securing the use of the leased asset (e.g., training or maintenance services for the leased asset).
- Not contract components of an arrangement are not related to lease services (e.g., reimbursement of certain lessors' costs such as property taxes and insurance) (ASC 842-10-15-30).

Once lessors and lessees have determined the components of an arrangement, they should allocate the value of the contract between different components based on ASC 842-10-15-28 through ASC 842-10-15-42.

Lessor Accounting

Practical Expedient

Lessors can follow a practical expedient, which, if elected, allows them to aggregate lease and non-lease components, if the following conditions exist, and account for them as a single component (ASC 842-10-15-37 and ASU 2018-20):

- Lease and non-lease components have similar timing and pattern of transfer.
- The standalone lease is classified as an operating lease if accounted for separately (i.e., the lessor does not perform a lease classification test).

In this practical expedient, if the non-lease component of an arrangement is predominant, lessor accounts for the arrangement as a single performance obligation based on ASC 606, *Revenue from Contracts with Customers* (including the variable consideration guidance). However, if the lease component is predominant, lessor accounts for the arrangement as a single component based on ASC 842, *Leases*.

Non-Practical Expedient

Fixed Payments. Lessors allocate fixed payments that include both lease and non-lease components to each component based on their relative standalone prices.

Variable Payments. Lessors allocate (rather than recognize) certain variable payments to lease and non-lease components of an arrangement. After the allocation, lessors recognize the amount of variable payments allocated to the lease components as income (ASC 842-10-15-40) as they are earned, while they recognize the amount of variable payments allocated to non-lease components in accordance with Topic 606 based on an estimate.

Lessors allocate variable payments that are based on a rate or index and include both lease and non-lease components to each component based on their relative standalone prices (similar to fixed payments discussed earlier based on the applicable rate and index at the commencement date) (ASC 842-10-30-5).

However, for the variable payments that are not based on rate or index and relate to non-lease components, lessors allocate the amount of transaction to specific non-lease components based on ASC 606, *Revenue from Contracts with Customers*. If feasible and consistent with ASC 606, lessors estimate the amount of variable consideration of different components based on their expected values or most likely amounts (ASC 606-10-32-8 through 32-41).

If the variable payments are not based on rate or index and relate to lease components, lessors do not include the variability at lease commencement for initial measurement, but allocate the variability to all components based on components' relative standalone prices once variability is eliminated.

FASB requires companies to account for the non-lease components of their lease contracts under their relevant applicable standards.

Lessee Accounting

Practical Expedient

Lessees can follow a practical expedient, which, if elected, allows them to allocate the aggregate lease and non-lease components as a single lease component (ASC 842-10-15-37). Otherwise, the lessees allocate the consideration in the contract to the separate lease components (ASC 842-10-15-28 through 15-31) based on observable or estimated standalone prices (ASC 842-10-15-33).

Non-Practical Expedient

Fixed Payments. Lessees allocate the lease payments that include both lease and non-lease elements to each component based on their relative standalone prices and account for them under ASC 842. Lessees, unlike lessors, do not have the option of accounting for these transactions under other GAAP Topics (such as ASC 606).

Variable Payments. Lessees allocate variable payments and include both lease and non-lease components to each component based on their relative standalone prices (similar to fixed payments discussed earlier).

Illustration

The following illustration reflects the accounting process for a multi-component arrangement.

Lessor agrees to lease equipment to a lessee for $22,000 for two years. Lessor also provides for two years maintenance services of the equipment for as long as lessee operates the equipment at 80% of its capacity or lower. Lessee reimburses lessor for $22,000 at the beginning of the arrangement and does not expect to exceed the 80% utilization stipulated in the contract.

Lessor concludes that the lease arrangement has a non-lease component as a distinct element. Therefore, it allocates the amount of the agreement to lease and non-lease components based on their relative standalone prices since the payments are fixed.

The standalone components of the arrangement are as follows: $11,000 per year for a total of $22,000 for two years. Maintenance amounts to $1,100 per year for a total of $2,200 for two years. Table 1 reflects the additional information.

Lessee classifies the lease arrangement as an operating lease and, similar to lessor, allocates the lease payments that include both lease and non-lease components to each component based on their relative standalone prices. Therefore, it reflects the journal entry in Table 2 for the first year (ignoring the ROU and the corresponding lease liability journal entry) (ASC 842-10-55-150 through 842-10-55-151 and ASC 842-20-25-6 and 842-20-55-1 through 55-2).

Lessor's allocation of the consideration is the same as lessee (ASC 842-10-55-152 and ASC 842-10-15-39 through 15-40). Lessor's journal entry for the first year for the lease transaction, accounted for as an operating lease, is shown in Table 3.

Table 1.

	Standalone Price	Relative Standalone Price
Equipment	$22,000	$20,000
Maintenance	$2,200	$2,000

Table 2.

Lease expense	$10,000	
Prepayment	$11,000	
Maintenance expense	$1,000	
Cash		$22,000

Table 3.

Cash	$22,000	
Lease revenue (ASC 842)		$10,000
Advance receipts		$10,000
Maintenance revenue (ASC 606)		$1,000
Deferred maintenance revenue		$1,000

Embedded Not Contract Components (e.g., Sales Tax and Other Similar Taxes)

The guidance in Topic 842 requires lessors to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased or whether those taxes are collected by the lessor on behalf of third parties.

Lessor Accounting

Lessors frequently incur certain costs (e.g., sales and property taxes) that they typically recover from lessees. These payments do not result in transfer of any goods or services to the lessee in addition to the lease or any non-lease goods and services included in the lease arrangements (ASC 842-10-15-30(b)).

ASU 2018-20 provides relief to lessors similar to ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, whereby an entity can make an accounting policy election to exclude or include from revenue amounts collected from customers for sales taxes. ASU 2018-20 provides an accounting policy election for lessors similar to the accounting policy election in ASU 2016-12.

Practical Expedient

Pursuant to ASU 2018-20, lessors, as an accounting policy election (applicable to all of their leases), may choose the practical expedient to present consideration that they receive from lessees or variable payments that they receive from them net of all taxes (ASC 842-10-15-39A).

Thus, lessors do not need to evaluate whether certain sales taxes and other similar taxes are lessors' costs (as described in paragraph 842-10-15-30(b)) or lessees' costs. Instead, lessors account for such taxes as if they were lessees' costs. If so, the lessors need to disclose that election in their financial reports (ASC 842-30-50-14). This is similar to the practical expedient for sellers under Topic 606 (ASC 606-10-32-2A).

Non-Practical Expedient

Lessors make a determination about who has the responsibility for the payment of taxes on jurisdiction-by-jurisdiction basis (i.e., lessee or lessor) and subsequently record the transaction on a gross or net basis:

- On a gross basis, when the lessor is responsible and recovers its costs from the lessee through fixed leased payments, it recognizes its costs and lessee's fixed lease payments separately (on a gross basis) as operating expenses and lease income.
- On a net basis, when lessee is responsible and remits the costs, lessor presents the cost and the lessee's payment on a net basis.

Lessors frequently incur certain costs (e.g., sales and property taxes) that they typically recover from lessees.

Collection for Third Parties

When a lessor collects sales (or other similar) taxes from a lessee on behalf of third parties (that is, the lessor is acting as an agent), the lessor excludes that amount from the (lease) revenue. If the lessor is primarily obligated for payment of the taxes paid by the lessee on behalf of the lessor, the lessor accounts for the payment as a lessor cost and includes that amount in (lease) revenue and costs (ASC 842-10-15-40A).

Embedded Taxes in Non-Lease Components

ASC 842 requires lessors to record revenues and expenses (e.g., taxes and insurance) for the embedded non-lease components at gross level because the costs are the lessor's costs of owning the assets.

This is applicable regardless of whether the expenses are embedded in lease payments, paid by the lessee directly to taxing authorities or service provider directly, or paid by the lessor and subsequently reimbursed by the lessee. This results in higher revenues and expenses for lessors and may also create an administrative burden for them to obtain certain information from lessees.

Lessee Accounting

The treatment of tax payments, assuming that the lessee is the primary obligator for tax, depends on whether the tax is incurred at or before lease commitment or over the lease term (ASC 842-20-25-5 or ASC 842-20-25-6):

- If a lessee makes tax payments at or before lease commencement, consistent with its accounting policy, it can either capitalize it as part of the cost of the RSU asset by analogy to the guidance in Topic 360, *Property, Plant and Equipment*, or it can expense is as incurred.
- If a lessee commits to pay taxes over time, it must recognize the tax obligation at the commencement of the lease in a separate account as a financial liability and as part of the cost of the RSU asset, by analogy to the guidance in Topic 360, *Property, Plant and Equipment*. As an alternative, it can expense the tax obligation as incurred.
- If the lessee makes variable non-lease tax payments, it should recognize it as any other period cost. In other words, it should not recognize it as part of the cost of the ROU asset.

Complexity of Embedded Lease Transactions

Management needs to exercise significant judgment to identify the embedded transactions in an arrangement. For example, a service arrangement that involves the use of a device may contain an embedded lease if the device can be identified implicitly or explicitly and the customer controls this device. Furthermore, an arrangement may contain lease, non-lease or other components. In these scenarios, both lessees and lessors need to identify separate components and properly account for them based on relevant accounting guidance.

The lease guidance and its amendments adduce to several other standards to account for embedded transactions in lease and non-lease arrangements. As a result, it would be challenging for practitioners to navigate through the labyrinth of multiple guidance and decipher all the nuances involved. This article provided a general framework that CPAs can reference to research the complexity of the issues involved in an emblematical lease transaction.

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CPE ARTICLE: EMBEDDED COMPONENTS IN LEASE AND NON-LEASE ARRANGEMENTS

By Josef Rashty

Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

1. **The following guidance is within the scope of this article:**
   a. ASC 842
   b. ASU 2018-11
   c. ASU 2018-20
   d. All of the above

2. **FASB requires that companies consider multiple arrangements as a _______ contract for the purpose of identifying embedded leases if a company has entered into these arrangements simultaneously or within a short span of time.**
   a. Single
   b. Voided
   c. Confusing
   d. Fraudulent

3. **FASB considers inflation-indexed lease arrangements that vary based on increases in CPI (customer price index) or PCE (personal-consumption expenditures) as _______.**
   a. Irrelevant
   b. Clearly and closely related
   c. Non-GAAP arrangement
   d. Irregular

4. **Lessees can follow a practical expedient, which, if elected, allows them to allocate the aggregate lease and non-lease components _______.**
   a. As multiple leases
   b. As they wish
   c. Arbitrarily
   d. As a single lease component

5. **Lessees allocate the fixed lease payments that include both lease and non-lease elements to each component based on their _______ and account for them under ASC 842.**
   a. Fair values
   b. Book values
   c. Relative standalone prices
   d. None of the above

6. **ASU 2018-20 provides relief to lessors similar to the new revenue guidance in ASU 2016-12 that they:**
   a. Include in revenue amounts collected from customers for sales taxes
   b. Exclude from revenue amounts collected from customers for sales taxes
   c. Make a policy election to exclude or include from revenue amounts collected from customers for sales taxes
   d. None of the above

7. **Pursuant to ASU 2018-20, lessors may choose the practical expedient to present consideration that they receive from lessees or variable payments that they receive from them _______.**
   a. Net of all taxes
   b. Gross of all taxes
   c. As they wish
   d. None of the above

8. **On non-expedient cases, when lessee is responsible and remits the costs, lessor presents the cost and the lessee's payment on _______.**
   a. A gross basis
   b. An arbitrary basis
   c. A net basis
   d. A partially net basis

9. **When a lessor collects sales taxes from a lessee on behalf of third parties, the lessor _______ that amount from the (lease) revenue.**
   a. Includes
   b. Excludes
   c. Incorporates
   d. Either a or b

10. **The article claims that lease guidance and its amendments ________ several other standards to account for embedded transactions in lease and non-lease arrangements.**
    a. Do not rely on
    b. Ignore
    c. Criticize
    d. Adduce to

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