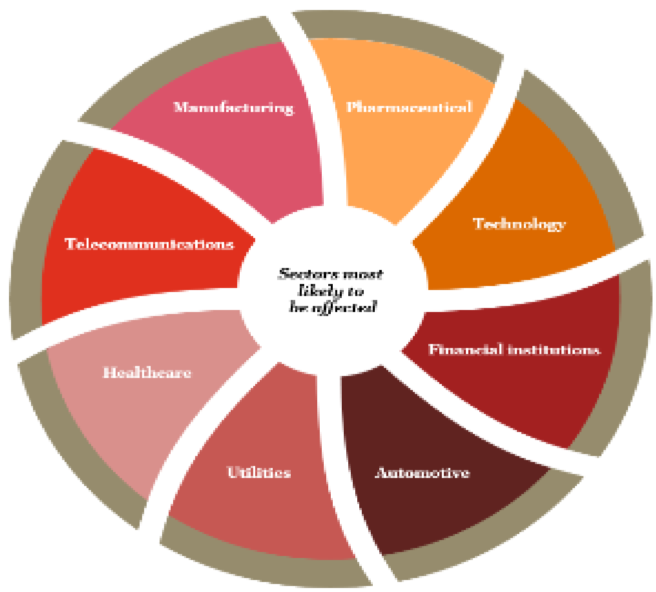
In the loop
March 2016

Are leases embedded in your contracts?

What you need to know

- The FASB's new lease accounting standard requires lessees to record an asset and liability on the balance sheet for nearly all leases.
- Identifying embedded leases is important to avoid misstating the balance sheet.
- As a general rule, an embedded lease exists if there is an explicit or implicit asset in the contract and the customer controls use of the asset.
- If you identify an embedded lease, you need to separate the contract into its lease and nonlease components and allocate consideration to each. Then, you need to classify each embedded lease as an operating or finance lease. Reassessment of these conclusions may be required.
- Changing certain contract terms may change the conclusion regarding whether an arrangement contains an embedded lease.

Does your company outsource its manufacturing? Do your supply arrangements bundle services and a device? Does your company rely on suppliers for products? Do you have data center arrangements?



The FASB recently issued its new lease accounting standard. Under the new guidance, lessees will recognize an asset and liability for nearly all of their leases. This requirement also applies to any leases embedded in other arrangements, like supply contracts, data center agreements, and outsourcing agreements.

While current leasing guidance requires that embedded leases be identified and accounted for separately, most lessees were not always diligent in doing so because typically, they were off-balance-sheet and did not have a material impact on the income statement. But under the new guidance, balance sheet amounts will be misstated if embedded leases are not identified and accounted for appropriately.

The requirement in the new leases standard to identify and account for embedded leases could have a significant impact on companies that rely heavily on outsourcing, data centers, bundled goods and services contracts, or other similar arrangements.

Identifying an embedded lease

There is judgment involved in assessing if an arrangement contains an embedded lease. The general rule under the new model is that an arrangement contains a lease if (1) there is an explicit or implicit asset in the contract, and (2) the customer controls use of the asset.

There is an embedded lease - what's next?

Once you identify an embedded lease, the contract needs to be separated into its lease and nonlease components. A component is an item or activity that transfers goods or services to the lessee. Under the new guidance, items such as property taxes and insurance that the lessee pays to the owner are not separate components because the lessee does not obtain a separate good or service for them. Instead, they are considered as part of the lease payment.

The next step is to allocate the contract consideration among the identified components based on their relative, observable standalone prices. The standalone prices for the lease versus nonlease components might not be readily apparent, and you may have to get the information from the lessor, or make an estimate if the lessor is not willing to share such information. Finally, each embedded lease component needs to be classified as an operating or finance lease. The classification will determine the specific balance sheet presentation and the expense recognition model (straight-line rent expense for an operating lease and front-loaded expense for a finance lease).

Reassessment

The new guidance adds more circumstances that require reassessment, and if necessary, reallocation and reclassification. The reassessment requirements in the new standard - which go well beyond actual modifications - are a significant change from today. Lessees will need new processes to monitor changes in circumstances that require revisions to lease accounting.

What lessees should consider

How an arrangement is structured can impact whether it contains an embedded lease. For example, contracts that specify particular assets may be accounted for differently than those in which the supplier can substitute the assets. Similarly, different provisions may influence the conclusion regarding whether the lessee controls the use of the asset.

Join our webcast and take our lease accounting survey

Webcasts on March 3 (replay available) and March 17

Survey: How will the new standards impact you?

In the loop

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How PwC can help

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