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Accounting for Leases Under ASC 842

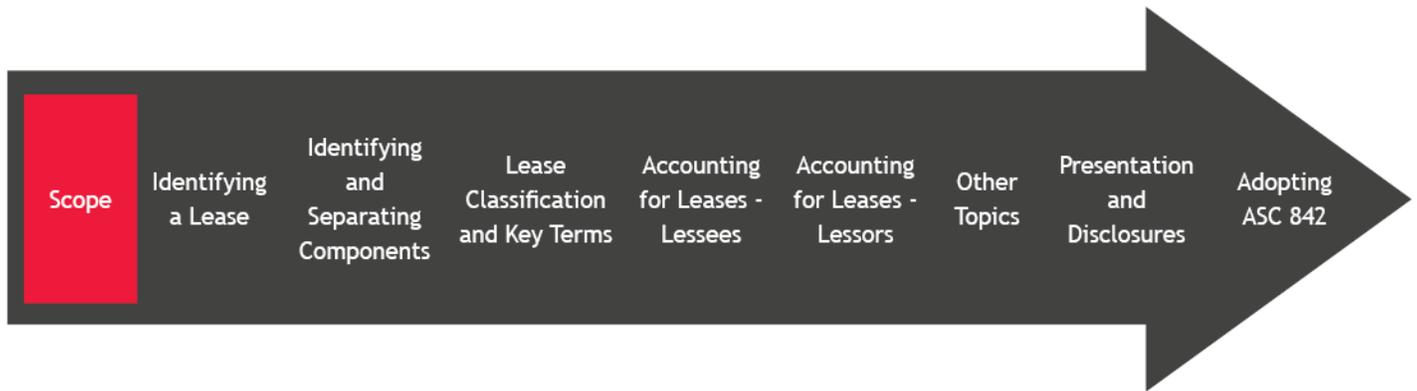


UPDATED SEPTEMBER 2021





BDO Knows Scope of ASC 842



SCOPE AND SCOPE EXCEPTIONS

ASC 842 is limited to leases of property, plant or equipment. Accordingly, it does not apply to any of the following:

LEASED ASSET		RELEVANT GUIDANCE AND OBSERVATIONS
Leases of intangible assets, like licenses of IP		Apply ASC 350, Intangibles—Goodwill and Other
Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources		Apply ASC 930, Extractive Activities—Mining, and ASC 932, Extractive Activities—Oil and Gas <i>The FASB clarified that the scope exception applies to the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained, unless those rights of use include more than the right to explore for natural resources. The scope exception does not apply to equipment used to explore for the natural resources. See Example 1 below for an illustration.</i>
Leases of biological assets, like plants and living animals		Apply ASC 905, Agriculture <i>Note that this scope exception includes timber to be consistent with ASC 840.</i>
Leases of inventory		Apply ASC 330, Inventory
Leases of assets under construction		Apply ASC 360, Property, Plant, and Equipment <i>Note that transactions in which the underlying asset needs to be constructed or redesigned for use by the lessee may be in scope of the sale-leaseback guidance if the lessee controls the asset under construction before the lease commencement date. See article on Other Topics for additional details.</i>

Scope of ASC 842 Consistent with ASC 840

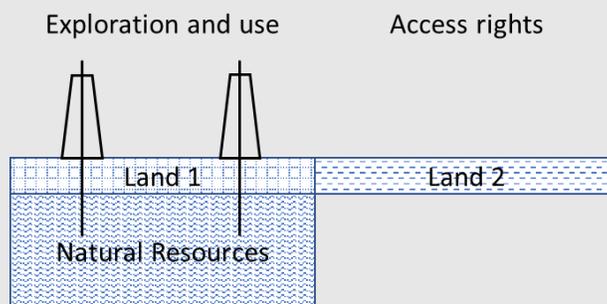
The scope of ASC 842 is generally consistent with the scope of the legacy lease guidance in ASC 840 and applies only to leases of property, plant or equipment (that is, land and/or depreciable assets). The Board acknowledged in paragraph BC110 in the Basis for Conclusions of ASU 2016-02 that the conceptual basis for excluding some other assets such as intangible assets, inventory and assets under construction from the scope of ASC 842 was unclear, but it nonetheless decided to continue to limit the scope to only property, plant or equipment for pragmatic reasons including cost-benefit reasons.

Long Term Leases of Land Not Excluded from ASC 842

The scope of ASC 842 includes long-term leases of land, such as a 99-year lease of land. While some may view these long-term leases of land as economically similar to purchases of land, the Board noted that there is no conceptual basis for differentiating long-term leases of land from other leases and that any definition of “long-term” would be arbitrary in nature. Accordingly, those long-term leases of land are in the scope of ASC 842.

Example 1 - Rights to Explore for or Use Natural Resources and Additional Rights

Entity A obtains the intangible right to explore for or use natural resources along with rights to use the land that contains those natural resources (Land 1). To access Land 1 and explore for those natural resources, Entity A obtains access rights to an adjacent parcel (Land 2). The following picture summarizes Entity A’s arrangements.



Which of the above rights, if any, are outside the scope of ASC 842?

ASC 842-10-15-1(b) states that the scope exception includes “the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained [...]”. Accordingly, the intangible right to explore for or use natural resources along with rights to use Land 1 are outside the scope of ASC 842. This would be true even if Entity A entered into separate contracts with different parties for the rights to Land 1 and for the rights to explore for the underlying natural resources (for example, if the surface rights are legally separated from the mineral rights and are owned by different parties).

However, the scope exception does not apply to the rights to use Land 2 as the scope exception is limited to the rights to use the land in which the natural resources are contained and for which Entity A has exploration rights (i.e., which is Land 1 only). Accordingly, Entity A should determine whether its right to access or use Land 2 meets the definition of a lease. See also section below on specific considerations for land easements.

Note that if Entity A were also to lease (rather than own) the equipment used for the exploration or use of the natural resources (such as the drilling rigs in the picture above), those would be in the scope of ASC 842 and Entity A would need to determine whether its right to use the equipment meets the definition of a lease.

SPECIFIC CONSIDERATIONS FOR LAND EASEMENTS

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in various industries, such as in the energy, utilities, transportation and telecom industries. For example:

- ▶ A midstream energy company might acquire a land easement for the right to pass a pipeline over, under, or through an existing area of land while allowing the landowner continued use of the land for other purposes (farming, hunting, etc.) if the landowner does not interfere with the rights of the midstream energy company.
- ▶ An electric utility might acquire a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by others.

Terms of land easements can vary greatly between agreements. For example, a land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, may be prepaid or paid over a defined term, and so forth. The grantor (landowner) also may retain rights associated with access and use of the land area, or it may be restricted in its ability to access and use the land area.

Diversity in practice has historically existed in U.S. GAAP in the accounting for land easements before ASC 842. For example:

- ▶ Some entities have accounted for their land easements as intangible assets based on the guidance in Example 10 of ASC 350-30, Intangibles—Goodwill and Other—General Intangibles Other than Goodwill, which refers to land easements in that example as intangible assets.
- ▶ Some entities have applied ASC 360 and considered the prepaid land easement as a cost to bring property, plant or equipment (for example, a pipeline) to the condition and location necessary for its intended use.
- ▶ Some entities have applied ASC 840 (for example, a cell tower company entering into a land easement for the right to erect a communication tower).

Because of that diversity, in January 2018, the FASB issued ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842, to clarify that land easements are in the scope of ASC 842. However, considering the existing diversity in accounting and to reduce the cost and complexity associated with assessing whether all existing and expired land easements meet the definition of a lease for entities transitioning to ASC 842, ASU 2018-01 allows entities that previously did not *account for* land easements as leases under ASC 840 to elect a transition practical expedient to not assess those land easements under ASC 842 when adopting the new standard. Instead, entities will continue to account for those land easements under other GAAP unless the land easement is modified on or after ASC 842's adoption date. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient for those easements.

Because the Board clarified in ASU 2018-01 that land easements are in the scope of ASC 842, once an entity adopts the new lease standard, it must apply that guidance prospectively to all new or modified land easements to determine whether those arrangements meet the definition of a lease under ASC 842.

Practical Expedient Provided for Cost-Benefit Reasons

Through outreach with stakeholders in industries most involved with land easements, the FASB learned that many land easements are perpetual (and therefore would not meet the definition of a lease because they are not “for a period of time”) and that many land easements are prepaid and therefore already recognized on the balance sheet. The Board therefore did not want entities to incur significant time and effort (considering the volume of land easements and age of those agreements) to evaluate them under ASC 842, especially considering that adoption of the new standard was generally not expected to have a material impact for these existing land easements.

While diversity in practice in accounting for land easements exists before ASC 842, it generally would be inappropriate for an entity to change its accounting policy prior to adoption of ASC 842 from accounting for those as leases under ASC 840 to accounting for those under ASC 350 or ASC 360.

Example 2 - Land Easements in Transition

Electric Company obtained a series of easements years before its adoption of ASC 842. The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company will make payments over time under the easement agreement in return for long-term access rights. Electric Company has historically accounted for those land easements along with its poles as property, plant and equipment under ASC 360.

Because Electric Company did not *account for* those land easements as leases under ASC 840, it can elect the practical expedient provided in ASU 2018-01. This means Electric Company will continue to account for those land easements under ASC 360 unless the agreement is modified on or after ASC 842’s adoption date, in which case Electric Company would need to assess whether those easements meet the definition of a lease under ASC 842. If elected, the practical expedient must be applied to all Electric Company’s land easements not accounted for as leases under ASC 840.

Alternatively, if Electric Company does not elect the land easements practical expedient, it should evaluate all of its existing land easements when adopting the new standard to determine whether those easements meet the definition of a lease under ASC 842.

Unit of Account Questions on Land Easements and Subsurface Rights Not Addressed

As part of its project leading to the issuance of ASU 2018-01, the FASB became aware of several unit of account questions commonly arising with land easements impacting the lease evaluation under ASC 842. For example, a midstream energy company may acquire a land easement for the right to pass a pipeline under an existing area of land in which the landowner retains rights associated with the use of the land surface. In this example, a question arises as to whether the subsurface area represents its own unit of evaluation, or whether the subsurface and surface should be considered together when evaluating whether the contract contains a lease. This question is important as it is more likely that the arrangement would contain a lease if the subsurface is considered its own unit of evaluation. Despite those questions, the FASB decided not to provide additional clarity as it did not view these issues as being limited to land easements. If an entity determines that an arrangement does not contain a lease, it applies other GAAP such as ASC 350 or ASC 360 to account for the arrangement.

For arrangements similar to the midstream energy company example above, we believe that it would be acceptable for the entity to either apply ASC 842 and evaluate whether the arrangement contains a lease, or to analogize the subsurface rights to air rights (i.e., an intangible asset, which is outside the scope of ASC 842) to the extent the rights conveyed relate to subsurface (underground) space that cannot be inhabited or otherwise be accessed (which are characteristics shared with air rights). In the latter situation, the entity would not apply the definition of a lease in ASC 842 but would apply other GAAP such as ASC 350 to its arrangement. However, we do not believe that an analogy to air rights is acceptable in all cases. For example, it would be inappropriate for an entity to analogize to air rights for leases of underground retail space in a subway station, a basement of a commercial office building, or underground parking garage. Careful consideration should also be given when determining the appropriate accounting for land easements as terms and conditions may vary greatly between arrangements.

Diversity in Accounting When a Land Easement is *Not* a Lease Also Not Addressed

When an entity evaluates a land easement under ASC 842 and determines it is not a lease, the diversity in accounting observed outside of the lease guidance is not addressed in ASU 2018-01. As previously discussed, some entities have applied ASC 350 while others have applied ASC 360. The FASB noted in paragraph BC11 of ASU 2018-01 that it did not intend to address diversity in the guidance applied when a land easement does not meet the definition of a lease. For example, consider an entity that accounts for its land easements as intangible assets before adoption of ASC 842 based on the guidance in Example 10 of ASC 350-30. If that entity enters into a land easement after adoption of ASC 842 but the contract does not include a lease, the entity's past practice of accounting for those arrangements as intangible assets is not affected by ASU 2018-01.

INTERACTION WITH OTHER STANDARDS

DERIVATIVES AND HEDGING

ASC 815-10-15-79 on scope and scope exceptions explains that leases that are within the scope of ASC 842 are not derivative instruments subject to the guidance on derivatives and hedging. However, a derivative instrument embedded in a lease may be subject to the requirements of ASC 815-15-25 on recognition of embedded derivatives.

ASC 815-10-15-80 also explains that residual value guarantees that are subject to the guidance in ASC 842 are not subject to the guidance on derivatives and hedging. However, ASC 815-10-15-80 clarifies that a third-party residual value guarantor should consider the guidance on derivatives for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in ASC 815-10 on derivatives and hedging.

SERVICE CONCESSION ARRANGEMENTS

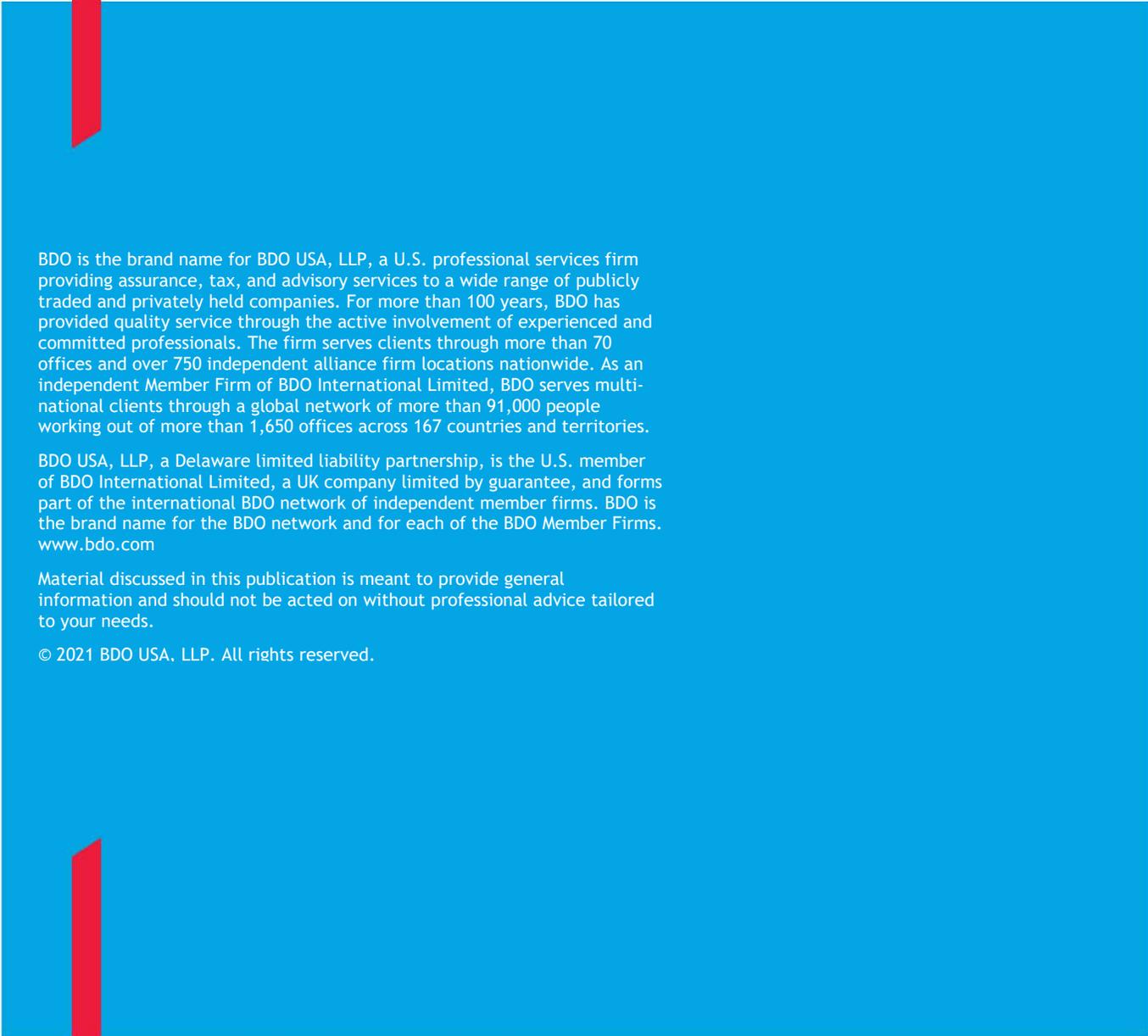
ASC 853-10-25-2 notes that the infrastructure that is the subject of a service concession arrangement within the scope of ASC 853 should not be recognized as property, plant, or equipment of the operating entity and that those service concession arrangements are not within the scope of ASC 842.

REVENUE FROM CONTRACTS WITH CUSTOMERS

ASC 606-10-55-68 notes that if an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. That paragraph also notes that if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset, the entity accounts for the contract as a lease (unless the contract is part of a sale-leaseback transaction). If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with ASC 842-40.

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