Hot Topic: ASC 842

Finding embedded leases under Topic 842

Embedded leases in existing contracts may not have been identified; companies need to look critically at their current lease population as part of their adoption of Topic 842.

Key impacts

Many contracts may contain leases that were not identified under Topic 840. These contracts may not use terms such as 'lease' or 'rent' that identify the embedded lease, and, given the limited impact under current guidance (primarily only a disclosure issue), companies may not have identified these embedded leases. However, identifying leases and the lease disclosures under Topic 840 become more important under, and leading up to the adoption of, the new leases standard (Topic 842).

Chapter 3 of KPMG's Handbook, Leases, provides guidance on identifying leases, including embedded leases, under Topic 842. However, if a company elects the 'package of practical expedients' available in transition to Topic 842, it applies the guidance in *Topic 840* when identifying embedded leases, rather than the definition of a lease in Topic 842. And regardless of whether a company elects the package of practical expedients, it applies the Topic 840 guidance when preparing its disclosures under Topic 840 before its adoption of Topic 842. Therefore, this article provides guidance on identifying embedded leases under Topic 840.

Identifying embedded leases

Under Topic 840, embedded leases can be present in many different types of contracts. Some areas where they are commonly identified include:

- IT service contracts
- 'as-a-service' contracts
- sales contracts
- supply contracts
- dedicated manufacturing capacity.

Embedded leases may also exist in some advertising, transportation or construction arrangements, and in related party transactions.

Companies should first identify arrangements where previously unidentified embedded leases may exist. Companies might *start* with those in the areas outlined above. Additionally, we believe the most likely population of unidentified embedded leases are those that may meet the criterion in paragraph 840-10-15-6(c):

> ***15-6*** *An arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if any of the following conditions is met:*
>
> *…*
>
> *(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.*

We believe companies are more likely to have identified as leases rights to use assets such as vehicles or machines that their personnel are actively operating, or assets like buildings (or parts of buildings) to which they control physical access.

This initial step of identifying 'at-risk' classes of transactions should involve representatives from multiple functions in the organization, because employees in operational capacities may be more familiar with the specific terms and deliverables of relevant contracts.

The search for embedded leases might begin by selecting a relevant sample of contracts in at-risk arrangements and expanding that sample as needed based on initial results. For example, if initial reviews identify previously unidentified leases, it will likely be prudent to expand the contract review to additional contracts within that class; or to add additional classes of transactions with a similar embedded lease risk profile to the company's procedures.

This process will frequently include significant efforts to review contracts and critically evaluate whether the terms create a right to control the use of an asset. Especially initially, this effort may require significant involvement of more experienced and technically proficient company personnel. Ultimately, this process should continue until the company is able to ensure that no material population of unidentified leases remains.

When a company identifies a previously unidentified lease, it should immediately include the future 'minimum rental payments'[1] associated with the lease in its Topic 840 financial statement disclosures. Furthermore, under the Topic 842 transition provisions, the minimum rental payments determined under Topic 840 form the basis for the new lease assets and liabilities that will be recognized. Because embedded leases are often part of contracts that include 'substantial service' non-lease elements, it is important to remember that the minimum rental payments only include the payments allocated to the lease component in the disclosure; payments for substantial service elements are not included.[2]

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1. See paragraphs 840-10-25-5 – 25-6; and Question 13.3.10 in KPMG's Handbook, Leases.
2. See paragraph 840-10-15-19; and the comparisons to legacy US GAAP in sections 4.2 and 4.4 in KPMG's Handbook, Leases.

Examples

The following are examples of embedded leases companies have identified under the guidance in Topic 840 as part of their Topic 842 implementation efforts; these companies elected the package of transition practical expedients.

Example 1:
Specialized production facility

Background

Customer enters into a contract with Supplier to purchase all of the widgets produced by a specialized facility for 12 years. The contract specifies the facility, and the widgets cannot practically be provided by Supplier from another asset. Supplier operates and maintains the facility.

Customer cannot change the output of the facility because it is specially designed; the facility can only produce the specialized widgets that it was designed to produce. However, Customer decides whether and how many widgets (i.e. how much output) the facility produces by changing its purchase levels. There is a quarterly minimum payment required of Customer regardless of how many widgets it orders.

Evaluation

There is an embedded lease under Topic 840:

- there is a specified asset upon which the contract depends (i.e. the specialized facility); and
- Customer controls the use of the facility. This is because Customer will take all of the output from the facility, and the pricing for the contract is not fixed per unit of output or equal to the market price per unit of output at the time of its delivery (due to the quarterly minimum payment).

Example 2:
Shuttle service

Background

Company's headquarters is a large campus. Employees and visitors frequently have to travel between buildings and to parking lots that are far apart from each other.

Company engages Shuttle Service to shuttle employees and visitors around the company campus. The buses used by Shuttle Service are dedicated to the Company contract – e.g. they may reside on campus full-time (in an on-site garage) or be customized for Company in terms of being branded for Company.

Company dictates the routes, frequency and hours of operation for the shuttle service, while Shuttle Service operates and maintains the buses. Company pays Shuttle Service a fixed fee each month for the service.

Evaluation

There is a lease under Topic 840:

— the buses are implicitly specified because it would be uneconomical for Shuttle Service to constantly shift resources used to satisfy this contract, even if it had other comparable buses not dedicated to this contract;3 and

— Company controls the use of the buses. This is because it will take all of the output from the buses (they are dedicated to Company's contract) and the pricing for the contract is not on a per unit fixed basis (e.g. a fixed rate per mile or per passenger). The fact that Shuttle Service operates and maintains the buses does not affect this conclusion.

Example 3:
Outsourcing arrangement

Background

Company outsources its call center function to a third party (Outsourcer) based overseas. Company pays Outsourcer both fixed and variable fees that are based on the type and quantity of activities that Outsourcer undertakes fulfilling Company's contract.

Outsourcer has set up the Company call center operation in a specified portion of its facilities and has dedicated specific equipment to fulfilling Company's contract – e.g. IT and telecommunications equipment. Neither the space, nor the equipment, is specialized. Outsourcer has the right and practical ability to relocate the Company operation to another portion of its facility and to substitute alternative IT and telecommunications equipment. In fact, Outsourcer has frequently done so for similar contracts in the past when it has obtained new contracts and needed to optimize resources – e.g. relocate one operation to create a larger contiguous space for another, new operation.

Evaluation

There is not a lease under Topic 840 because fulfillment of the contract does not depend on the space or the equipment currently being used. Outsourcer has the right and practical ability to relocate the Company operation to another portion of its facility and to substitute alternative IT and telecommunications equipment.

This conclusion could change, and a lease might exist if, for example, Company's contract required a dedicated facility or specialized/customized equipment such that it would be impractical or uneconomical for Outsourcer to substitute. In that case, a lease might exist for the facility, the equipment or both because those assets would be dedicated to Company's contract (such that it would be remote that any party other than Company would receive more than a minor amount of the output from those assets), and the contract pricing is neither fixed per unit of output nor equal to the market price per unit of output at the time of its delivery. [3]

3. See the comparison to legacy US GAAP in section 3.2 in KPMG's Handbook, Leases.

Other considerations

Companies should have appropriate internal controls over the completeness and accuracy of the lease population underlying their Topic 840 lease disclosures. Those controls should address the company's identification of embedded leases, and also should address the completeness and accuracy of the Topic 840 disclosures, which will help create a baseline for the transition adjustment to Topic 842.

Effective date

Topic 842 is effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2018. It is effective for private companies for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. Early adoption is permitted for all entities.

For further information

For more information about the definition of a lease in Topic 842, including how the definition differs from Topic 840, see chapter 3 of KPMG's Handbook, Leases.

This Hot Topic is part of a series to highlight implementation issues that are discussed in KPMG's Handbook, Leases.