

ACCOUNTING STANDARDS CODIFICATION (ASC) 842, *Leases*

What is ASC 842?

In 2016, the Financial Accounting Standards Board (FASB) issued a new accounting standard on Leases. Under this new guidance, lessees will be required to bring substantially all leases – whether operating or capital leases - onto their balance sheets. The FASB's objective was to increase transparency and comparability across organizations.

This is the first major change in lease accounting guidance in 40 years and the impact on the University's financial statements is expected to be significant.

When is ASC 842 Effective?

The University must adopt ASC 842 in Fiscal Year 2020 with comparative data for FY 2019.

What is the definition of a lease under ASC 842?

A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration.

This definition does not apply to:

- a. Leases of intangible assets
- b. Leases to explore for or use non-regenerative resources
- c. Leases of biological assets
- d. Leases of inventory
- e. Leases of assets under construction

What are some of the key components of ASC 842?

1. All leases with a term greater than one year must be capitalized, i.e. an asset and related liability must be recorded on the balance sheet. Current guidance requires only capital leases to be recorded on the balance sheet. Operating leases – those that do not meet the criteria for capitalization – are currently recorded on the income statement as expenses are incurred.
2. While all leases will be capitalized, a distinction will be made between “operating” and “financing” leases. The difference between the two will center on how lease expenses (interest and amortization) will be recorded. Operating leases will record all lease-related expenses on a straight-line basis and financing lease will record all lease-related expenses using the effective interest method.

3. Certain service contracts may now fall under the provisions of ASC 842 if certain conditions are met. For example, if a service contract provides the right to control a specific asset(s) for a period of time, it may require lease accounting treatment. Examples may include:
 - a. Billboard advertising
 - b. Shuttle buses
 - c. IT Cloud services
 - d. Storage facilities
 - e. Fiber optic cable
 - f. Service contracts with possible lease components, e.g. print services
 - g. Antenna/telecommunications devices
 - h. Office trailers
 - i. Vending machines

These “embedded” leases may be in the form of a service contract, but depending on the terms and conditions, may require lease accounting under ASC 842. For example, if the arrangement conveys control over an identified asset with limited substitution rights on the part of the supplier, the arrangement may fall under the lease accounting standards of ASC 842.

The attached excerpt is from a document prepared by the accounting firm PwC. It provides a concise summary of what may constitute an embedded lease.

What is being done to prepare for implementation?

The Controller’s Office is currently partnered with the leadership in the Property Management Department in a working group tasked with implementing the new lease accounting standard.

What do we need from you?

It is important that you review the enclosed material and think about what leased product and/or service contracts you have in your area that may require lease accounting under ASC 842. The Controller’s Office will be reaching out to you this spring to discuss contracts in your area(s) and we may ask to review those agreements with you to determine if ASC 842 applies.

Embedded leases

Regardless of how an arrangement is structured, lease accounting guidance applies to any arrangement that conveys control over an identified asset to another party. An arrangement is a lease or contains a lease if an underlying asset is explicitly or implicitly identified and use of the asset is controlled by the customer.

If an arrangement explicitly identifies the asset to be used, but the supplier has a substantive contractual right to substitute such asset, then the arrangement does not contain an identified asset. A substitution right is substantive if the supplier can (a) practically use another asset to fulfil the arrangement throughout the term of the arrangement, and (b) it is economically beneficial for the supplier to do so. The supplier's right or obligation to substitute an asset for repairs, maintenance, malfunction, or technical upgrade does not preclude the customer from having the right to use an identified asset.

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors (e.g., point of entry or exit, access to lavatories). Capacity or a portion of an asset is not an identified asset if (1) the asset is not physically distinct (e.g., the arrangement permits use of a portion of the capacity of a storage space); and (2) a customer does not have the right to substantially all of the economic benefits from the use of the asset (e.g., several customers share a storage space and no one customer has substantially all of the capacity).

An institution (customer) controls the use of the identified asset by possessing the right to (1) obtain substantially all of the economic benefits from the use of such asset ("economics" criterion); and (2) direct the use of the identified asset throughout the period of use ("power" criterion). An institution (customer) meets the "power" criterion if it holds the right to make decisions that have the most significant impact on the economic benefits derived from the use of the asset. If these decisions are predetermined in the contract, the contract is a lease if the institution (customer) either (a) has the right to direct the operations of the asset without the supplier having the right to change those operating instructions throughout the period of use, or (b) has designed the asset (or specific aspects of the asset) that predetermines how and for what purpose the asset will be used throughout the period of use. Sometimes there may be terms in the contract that are included to protect the supplier's asset and supplier's personnel and comply with regulations. For example, a contract may restrict usage of the asset up to a maximum number of usage hours based on the asset's expected life and related depreciation. The existence of such protective rights in and of themselves do not prevent a customer from having the right to direct the use of an asset.

The new model differs in certain respects from today's risks and rewards model. Under current lessee guidance, embedded leases are often off-balance-sheet operating leases and, as such, application of lease accounting may not have had a material impact. Determining whether to apply lease accounting to an arrangement under the new guidance is likely to be more important since virtually all leases will result in recognition of a right-of-use asset and lease liability.

PwC observation:

Under the new guidance, balance sheet amounts will be misstated if embedded leases are not identified and accounted for as such. As colleges and universities typically operate in decentralized environments, it will be important to ensure a process is in place to identify who within the organization is able to enter into contracts and that such arrangements are communicated to those with financial accounting oversight on a timely basis. Failure to do so could result in the misstatement of the balance sheet.