What you need to know

- Oil and gas entities need to exercise judgment when applying the definition of a lease.
- Identifying a complete population of leases to be accounted for during transition and after the effective date will likely be one of the more challenging aspects of implementing the new standard.
- Entities need to change their accounting policies, processes, systems and internal controls, even if applying the standard doesn't have a significant effect on their financial statements.
- Entities with a significant number of leases are finding that implementation requires significantly more effort than they expected.

Overview

The effective date\(^1\) of the new leases standard\(^2\) by the Financial Accounting Standards Board (FASB or Board) is fast approaching for many entities. While lessees with significant operating leases will be most affected by the requirement to record assets and liabilities for most of these leases, all lessees and lessors will have to make changes to their accounting policies, processes, systems and internal controls to implement the standard.

The FASB issued an amendment\(^3\) adding a transition option that allows entities to not apply the new guidance in the comparative periods they present in their financial statements in the year of adoption. The amendment also provides an optional practical expedient for lessors to elect, by class of underlying asset, to not separate lease and related non-lease components when certain criteria are met. This publication will be updated again for this recently issued amendment.
The FASB tentatively decided to allow lessors to make a policy election to not evaluate whether sales taxes and other similar taxes imposed by a third party on a lease revenue-producing activity are the primary obligation of the lessor as owner of the underlying leased asset. A lessor making this election would exclude these taxes from the measurement of lease revenue and the associated expense. A lessor would apply the election to all taxes in the scope of the policy election. The Board also tentatively decided to require lessors to exclude certain lessor costs paid directly by lessees to third parties on the lessor’s behalf from variable payments if there is uncertainty in the amount paid that is not expected to ultimately be resolved. As a reminder, entities may only adopt final standards issued by the Board.

This publication summarizes the new standard (and certain amendments) and describes some relevant industry considerations for entities in the upstream, midstream, downstream and oil field service subsectors. Entities should consider these industry-specific issues when implementing the standard. Like all entities, oil and gas entities need to apply the standard to leases of office space, office equipment and all other leased assets.

This publication complements our Financial reporting developments (FRD) publication, Lease accounting: Accounting Standards Codification 842, Leases (SCORE No. 00195-171US), which provides an in-depth discussion of ASC 842. We refer to that publication as our ASC 842 FRD.

Key considerations

Scope and scope exceptions
The scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including 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 to use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources
- Leases of biological assets, including timber
- Leases of inventory (i.e., assets held for sale in the ordinary course of business, assets in the process of production for sale, assets to be currently consumed in the production of goods or services to be available for sale)
- Leases of assets under construction

The scope of ASC 842 excludes leases to explore for or use oil and natural gas, including the right to use land in which those natural resources are contained (unless those rights include more than the right to explore for natural resources). Entities will need to consider the rights included in contracts to determine whether the scope exemption applies to the right to use certain underlying assets.
Illustration 1: Application of the ASC 842 scope exception for oil and gas

Upstream Co. enters into a contract with Land Owner for surface rights to five square miles of land for 20 years. The contract specifies that four square miles of this land will be used to drill wells as part of the exploration for oil and gas reserves, while one square mile is contractually specified solely for the construction of a field office. Upstream Co. previously acquired the mineral rights from an unrelated third party. Upstream Co. must submit all construction plans to Land Owner in advance, and Land Owner may require changes to planned locations of well pads and the field office.

Analysis

Upstream Co. determines that the four square miles of surface rights used to access the mineral rights meet the scope exception in ASC 842 because they are rights to use land in which Upstream Co. has the intangible rights to explore for or use oil and gas resources. The one-square-mile section that is contractually specified for the headquarters facility is a separate identified asset and is in the scope of ASC 842 and Upstream Co. must determine if this identified asset meets the definition of a lease.

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration. See Appendix A for a flowchart from ASC 842 of how to determine whether an arrangement is or contains a lease.

Identified asset

The requirement that there be an identified asset is fundamental to the definition of a lease. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract. An identified asset also can be a physically distinct portion of a larger asset. Examples include a floor of a building, the “last mile” of a telecommunications network that connects a single customer to a larger network or a segment of a pipeline that connects a single customer to a larger pipeline (i.e., the segment is used solely by one customer). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any nonconsecutive periods of time). A substitution right is substantive when both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use.
- The supplier would benefit economically from the exercise of its right to substitute the asset.

Entities will need to evaluate whether substitution rights in contracts for assets used in the exploration and production of oil and natural gas, such as compression stations or fracking pumps, are substantive. This assessment will depend on the facts and circumstances of each contract.

Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset
If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset’s primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset and therefore are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.

- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Under ASC 842, determining whether certain contracts, particularly those involving a significant service component (e.g., contract manufacturing, supply agreements, transportation arrangements), contain a lease is more important for lessees than it is under the legacy guidance because lessees are now required to account for most leases on their balance sheet.

Oil and gas entities consider the criteria above when they determine whether the customer directs the use of other identified assets, including dedicated portions of gathering lines (e.g., well connections), pipeline segments or first or last miles.

While evaluating whether the customer directs the use of an identified asset will be straightforward in many arrangements, evaluating other arrangements – particularly those with a significant service component – may require more consideration.

For example, drilling contracts often require the supplier to provide and operate a drilling rig for a customer. The customer has the right to direct the use of the drilling rig when it makes the decisions that most significantly affect the economic benefits derived from the rig throughout the period of use (e.g., the customer has the right to determine when, whether and where the drilling rig operates and can change such decisions), even though it does not physically operate the rig.

In another example, in an arrangement to use a dedicated pipeline, the supplier may have the right to make the decisions that will most affect the economic benefits. This would be the case when the supplier has the right to determine the level of compression across its broader
system, decide whether to store unrelated customers’ products, park and borrow or park and loan product, or otherwise modify the assets (e.g., expand a gathering system) to serve other customers or potential customers. Evaluating when the supplier has such decision rights and whether they are substantive will require judgment based on the facts and circumstances of each arrangement.

The supplier may retain certain rights, such as the rights to make certain decisions to protect its investment in the asset (e.g., determining whether conditions are safe for operation), known as protective rights. However, a supplier’s protective rights, in isolation, do not prevent the customer from having the right to direct the use of the underlying asset.

**How we see it**

Because ASC 840’s accounting for operating leases and service contracts is similar, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under ASC 840 because, under ASC 842, most operating leases are recognized on lessees’ balance sheets, and the effects of incorrectly accounting for a lease as a service may be material.

The FASB noted in the Background Information and Basis for Conclusions (BC393(a)) that the practical expedient that permits entities not to reassess whether any expired or existing contracts contain leases does not grandfather incorrect assessments made under ASC 840 (i.e., the practical expedient applies only to arrangements that were appropriately assessed under ASC 840).

**Land easements**

Land easements are rights to use, access or cross another entity's land for a specified purpose. For example, a land easement might be acquired for the right to construct and operate a pipeline or other asset (e.g., telecommunication cables) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement. A land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of ASC 842, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual but are term based include:

- Very long-term contracts (e.g., the FASB indicated in the Basis for Conclusions (BC113) that very long-term leases of land (e.g., 999 years) are in the scope of ASC 842)
- Contracts with a stated, noncancelable lease term that “automatically renews” if the lessee pays a periodic renewal fee it is an in-substance fixed term contract with optional renewal periods
- Contracts that define the period of use as the period over which the assets are used (e.g., as long as natural gas flows through a gathering system) is a fixed term contract (i.e., terminated when production ceases) rather than a perpetual contract because the gas reserves will ultimately be depleted
When determining whether a contract for a land easement is a lease, entities will need to assess whether there is an identified asset (i.e., a distinct portion of land) and whether the customer has the right to direct the use of, and obtain substantially all of the economic benefits of, the identified asset throughout the period of use.

**Illustration 2: Subsurface pipeline land easement**

Midstream Co. enters into a 20-year contract with Land Owner for the right to bury a 10-inch diameter pipe three feet below the surface of the land. The contract specifies the exact location of the pipe and states that the property subject to the easement is a 10-foot-strip of land, extending five feet on either side of the center line of the pipe. Additionally, the contract provides access rights to Midstream Co. to install and maintain the pipeline for the duration of the contract (20 years). The terms of the contract permit Midstream Co. to use the property for a pipeline. However, Midstream Co. does not have the right to restrict access to the land. Land Owner has the substantive right to access the property above the pipeline and use it for farming, livestock or other purposes as long as that usage does not interfere with Midstream Co.’s use of the subsurface property.

**Analysis**

Midstream Co. determines that the contract includes a single unit of account (i.e., the identified asset is the property through which the pipeline passes). Midstream Co. determines that while it has access rights to the property, it does not have the right to obtain substantially all of the economic benefit of the identified asset, because Land Owner retains rights to economic benefits subject to the identified asset. Therefore, this contract does not contain a lease.

If Land Owner contracts with another third party to use the surface area above the pipeline, Land Owner and the third party would need to evaluate the contract under ASC 842.

**Illustration 3: Subsurface pipeline land easement (restricted access)**

Assume the same facts as Illustration 2, except that the contract also grants Midstream Co. the right to restrict access to the land easement that includes the surface area immediately above the pipeline. This right allows Midstream Co. to restrict access to the surface area above Midstream Co.’s pipeline through any methods Midstream Co. deems appropriate, including the use of signage or fencing.

**Analysis**

Midstream Co. determines that the contract includes a single unit of account (i.e., the identified asset is the property through which the pipeline passes). Midstream Co. determines that it has the right to obtain substantially all of the economic benefit of the identified asset. Additionally, Midstream Co. determines that it has the right to direct how and for what purpose the identified asset will be used throughout the period of use. Therefore, this contract contains a lease.

The FASB has amended the standard\(^5\) to provide an optional transition practical expedient for land easements existing prior to the date of initial application. Refer to the Transition section below for further guidance. The ASU also clarifies that an entity will evaluate land easements, entered into or modified on or after the effective date, to determine whether the contract meets ASC 842’s definition of a lease, before applying other guidance (such as ASC 350-50).
How we see it
Determining whether land easement contracts contain leases will require careful consideration of the rights and obligations in each arrangement. Because the nature of these contracts can vary by jurisdiction and counterparty, entities should design processes and internal controls to make sure they appropriately assess all new or modified contracts for potential leases.

Identifying and separating components of a contract and allocating contract consideration
For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of these conditions are met:

- The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee.
- The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

For contracts that involve the right to use land and other assets (e.g., land and a gas station), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee applies the practical expedients to not separate lease and non-lease components). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers).

Practical expedient to not separate lease and non-lease components – lessees
ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

How we see it
For many lessees in the oil and gas industry, identifying non-lease components of contracts may be a change in practice. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognized on lessees’ balance sheets under ASC 842, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.
Lease payments

Some lease agreements include payments that are described as variable or may appear to contain variability but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable. Such payments are included in the lease payments at lease commencement and, thus, are used in the classification test and to measure entities’ lease assets and lease liabilities.

For example, consideration paid for the use of drilling rigs is typically expressed as a rate paid for each operating day, hour or fraction of an hour. The types of rates a lessee may be charged include:

- Full operating rate – a rate charged when the rig is operating at full capacity with a full crew
- Standby rate or cold-stack rate – a rate charged when the lessee unilaterally puts the rig on standby
- Major maintenance rate – a minimal rate, or in some cases a “zero rate,” charged when the lessor determines that maintenance needs to be performed and the rig is not available for use by the lessee
- Inclement weather rate – a minimal rate, or in some cases a “zero rate,” charged when weather makes it dangerous to operate the rig and, therefore, it is not available for use by the lessee

There will likely be variability in the pricing of a drilling contract, but we believe, based on discussions with the FASB staff, that there typically is a minimum rate in drilling contracts. This amount would be the lowest rate that the lessee would pay while the asset is available for use by the lessee. Depending on the contract, this rate may be referred to using terms such as a standby or cold-stack rate. When identifying the lease payment in a drilling contract, an entity should only consider rates that apply when the asset is available for use.

How we see it

To appropriately classify and account for leases, entities will need to carefully evaluate the various rates included in each contract to determine whether such rates are lease payments.

Lease classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets any one of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset’s economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
• The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets both of the following criteria:

• The present value of the sum of lease payments and any residual value guaranteed by the lessee and any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

• It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the “substantially all” criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors reassess lease classification as of the effective date of a modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) that is not accounted for as a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

Oil and gas entities, particularly those with midstream and downstream activities, have historically considered ASC 840’s real estate-specific guidance to determine the classification of leases of land, buildings and integral equipment. Because the new standard eliminates the real estate-specific lease guidance, entities will follow the same classification guidance for leases of all assets.

ASC 842 also introduces a new classification criteria. A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, lessees and lessors should consider the effects of substantive contractual restrictions and practical limitations on the lessor’s ability to readily direct that asset for another use (e.g., sell it, re-lease it to an entity other than the lessee). A practical limitation exists if the lessor would incur significant economic losses to repurpose the underlying asset for another use (e.g., if the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss).
The example below illustrates the potential implications of the new classification criteria when evaluating sale and leaseback transactions, which are common transactions between master limited partnerships and parent sponsors. Also, refer to the Sale and leaseback transactions section below.

**Illustration 4 – Lease classification**

A downstream entity, Parent Co., operates an unregulated refinery in a remote area of North Dakota. The refinery complex includes a coker unit that is integrated into the refinery. Parent Co. sells the coker unit to its unregulated and consolidated master limited partnership (MLP) subsidiary and immediately leases the asset back for use in the refinery for five years. There is no transfer of ownership or option to purchase at the end of the lease term. The present value of the lease payments is $80 million. The fair market value (FMV) of the coker unit is $200 million, and the remaining economic life is 20 years. Due to the integration in the refinery, the MLP does not have a practical ability to re-lease or sell the asset to an entity other than Parent Co. without incurring significant cost.

*Analysis*

The MLP follows the sale and leaseback guidance and determines that the arrangement with Parent Co. qualifies as a sale of the asset under ASC 606 and that the leaseback for the use of the coker unit meets the definition of a lease. The MLP then assesses the classification criteria in ASC 842-10-25-2:

- The lease does not transfer ownership of the coker unit back to Parent Co. at the end of the lease term.
- The lease does not grant Parent Co. an option to purchase the coker unit.
- The lease term (five years) is not for the major part of the remaining economic life of the coker unit (20 years).
- The present value of the sum of the lease payments ($80 million) does not equal or exceed substantially all of the FMV of the coker unit ($200 million).
- The coker unit is highly integrated into the refinery and is not expected to have an alternative use at the end of the lease term.

Because the coker unit is not expected to have an alternative use at the end of the lease term, the MLP concludes that this lease is a sales-type lease (and Parent Co. concludes the lease is a finance lease). As a result, the MLP would determine that the transaction is a failed sale because the lease is classified as a sales-type lease. The MLP would account for the transaction as a financing transaction. In the example, the transaction would eliminate upon consolidation for Parent Co.

*How we see it*

Under the new leases standard, reassessing whether a modified contract is or contains a lease may result in changes to financial reporting from legacy GAAP. In addition to analyzing their facts and circumstances, entities need to update their accounting policies, processes, internal controls and other documentation to reflect the analysis required by the new standard.
Lessee accounting
At the commencement date of a lease, a lessee recognizes an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset) and a liability to make lease payments (i.e., the lease liability).

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842.

For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern. The periodic lease expense for operating leases is generally recognized on a straight-line basis.

Short-term leases recognition and measurement exemption
Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840’s operating lease accounting to leases that meet ASC 842’s definition of a short-term lease (i.e., the short-term lease exemption). A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date.

A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments as an expense on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease expense is reversed if it is probable that the specified target will no longer be met.

Lessor accounting
Sales-type lease accounting under ASC 842 generally requires lessors to derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize, in net income, any selling profit or selling loss. However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other US GAAP (e.g., depreciates, evaluates the asset for impairment in accordance with ASC 360) and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either of the following events occurs:
  - The contract is terminated, and the lease payments received from the lessor are nonrefundable.
  - The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract, and the lease payments received from the lessee are nonrefundable.
Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease (i.e., selling profit reduces the net investment in the lease). Any selling loss is recognized at lease commencement. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

For operating leases, lessors continue to recognize the underlying asset and do not recognize a net investment in the lease on the balance sheet or initial profit (if any). If collectibility of lease payments and residual value guarantees is probable at lease commencement, a lessor subsequently recognizes lease income over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments and any residual value guarantees is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

Other considerations

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions do not provide lessees with a source of off-balance sheet financing.

Both the seller-lessee and buyer-lessor are required to apply ASC 842 and certain provisions of ASC 606 to determine whether to account for a sale and leaseback transaction as a sale (seller-lessee) and purchase (buyer-lessor) of an asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (seller-lessee) or purchase (buyer-lessor) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties. Also, note that sale and leaseback transactions among entities under common control are subject to ASC 842-40’s sale and leaseback guidance.

Sale subject to a preexisting lease

A sale of an asset subject to a preexisting lease is not within the scope of ASC 842’s sale and leaseback guidance if the preexisting lease is not modified in connection with the sale. This may occur when an entity that has a non-controlling investment in a partnership that owns an asset and subsequently sells its interest in the partnership or alternatively, the partnership sells its interest in the underlying asset to an independent third party and continues to lease the underlying asset under the unmodified preexisting lease. In this case, the lease is considered a preexisting lease.

However, a sale subject to a preexisting lease between parties under common control is not a preexisting lease. As an exception, when one of the parties under common control is a regulated entity in the scope of ASC 980, Regulated Operations, and the lease has been approved by the appropriate regulatory agency, an unmodified lease with a related party should be considered a preexisting lease.
Illustration 5 – Sale subject to a preexisting lease – common control and no regulated operations

Assume a parent company (Entity A) has two consolidated subsidiaries both with standalone financial reporting requirements: Subsidiary B and Subsidiary C. Also, assume the following:

- Entity A, Subsidiary B and Subsidiary C do not have regulated operations subject to the guidance in ASC 980.
- Subsidiary B owns an asset (e.g., a pipeline) and leases it to Entity A.
- Subsidiary B transfers the underlying asset to Subsidiary C.
- Entity A continues to lease the underlying asset, except now it leases it from Subsidiary C.
- The lease is otherwise unmodified, other than to change the name of the lessor.
- Subsidiary B is relieved of its primary obligation under its lease with Entity A.

Analysis

In this example, the sale subject to a preexisting lease is not a preexisting lease; therefore, ASC 842-40's sale and leaseback guidance would be applicable. Each entity (Subsidiary B and Subsidiary C in their standalone financial reporting) would account for this transaction as follows:

- The transaction would eliminate in consolidation for Entity A (the seller-lessee).
- Since Subsidiary B is no longer the lessor, it follows other GAAP for the sale of the underlying asset to an entity under common control in its standalone financial reporting.
- Subsidiary C (the buyer-lessor) considers ASC 842-40's sale and leaseback guidance in its standalone financial reporting due to its acquisition of the underlying asset from Subsidiary B and its lease with Entity A.
  - If the transaction is accounted for as a sale and leaseback, Subsidiary C (in its standalone financial reporting) would follow the accounting model for lessors (refer to chapter 5, Lessor accounting, of our ASC 842 FRD) including performing a lease classification test. For other aspects of the transaction, the entity would follow the guidance for common control transactions (see our FRD publication, Business combinations).
  - If the transaction does not qualify as a sale, Subsidiary C (in its standalone financial reporting) would account for the transaction as a financing. Refer to section 7.4, Transactions in which the transfer of an asset is not a sale, of our ASC 842 FRD.

Illustration 6 – Sale subject to a preexisting lease – common control with regulated operations

Assume the same facts as Illustration 5, except as follows:

- Entity A, Subsidiary B and Subsidiary C operate in a regulated industry subject to the guidance in ASC 980.
- The lease between Entity A and Subsidiary B has been approved by an appropriate regulatory agency.
Analysis

In this example, the sale subject to a preexisting lease is a preexisting lease; therefore, ASC 842-40's sale and leaseback guidance would not be applicable. Each entity would account for this transaction as follows:

- The transaction would eliminate in consolidation for Entity A.
- Since Subsidiary B is no longer the owner-lessee, it follows other GAAP (in its standalone financial reporting) for the sale of the underlying asset to an entity under common control.
- Subsidiary C follows other GAAP (in its standalone financial reporting) for the purchase of the underlying asset from an entity under common control and recognizes a lease following the lessor model (refer to chapter 5, Lessor accounting, of our ASC 842 FRD).

Lessee involvement in asset construction

ASC 842 makes significant changes to how lessees and lessors will evaluate their involvement in asset construction. ASC 842 focuses on whether the lessee controls the asset being constructed to determine whether it is the accounting owner of an asset under construction, while ASC 840 focuses on whether the lessee has substantially all of the construction-period risk.

If the lessee controls the asset during the construction period, lessees and lessors will apply the sale and leaseback guidance when the construction of the asset is complete and the lease commences. If the lessee does not control the underlying asset being constructed, any payments made for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments. Lease payments made prior to lease commencement are recognized as a prepaid asset and evaluated in the lease classification test. Costs incurred by the lessee (when the lessee does not control the asset during construction) that relate specifically to construction or design of an asset that are not payments for the use of an asset to be leased are recognized in accordance with other US GAAP (e.g., ASC 330, Inventory; ASC 360, Property, Plant, and Equipment).

For guidance on accounting for lessee involvement in construction and related transition guidance refer to our ASD 842 FRD.

Lease modifications

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. For example, a modification may occur when entities agree to expand the leased capacity in a storage or transportation contract or when entities agree to terminate a portion of a contract, such as a reduction in the scope or timing of a drilling contract.

In a change from today’s guidance, lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original lease) when certain conditions are met. How an entity will account for modifications that do not result in a separate contract will depend on whether the entity is a lessee or lessor, the nature of the modification and the classification of the lease before and after the modification.

Refer to our ASC 842 FRD for details on accounting for lease modifications.
**Joint operations**

Joint operations and joint arrangements are common in the oil and gas industry. This discussion only contemplates arrangements that are eligible for proportionate consolidate under US GAAP. Proportionate consolidation is permitted in the extractive industry for specific fact patterns. Refer to our FRD Consolidations for further guidance on proportionate consolidation. Joint operations or joint arrangements that are eligible for proportionate consolidate are collectively referred to in this section as “JOs”.

In a JO, an operator (e.g., an operator of an oil and gas property) may agree with other parties (i.e., nonoperators) to perform certain activities necessary to develop or operate the property. These arrangements are typically documented through the use of a joint operating agreement (JOA). To fulfill its responsibilities, the operator often enters into contracts with third-party suppliers to obtain the use of equipment (e.g., a drilling rig) to perform the activities. Many of these arrangements may contain leases. The parties to each supplier agreement (i.e., the supplier and either the operator or the JO) will have to carefully evaluate the terms to determine which party controls the use of an identified asset throughout the period of use. This assessment will often require two steps:

- **Step 1**: Determine which party or parties are counterparties to the contract with the supplier (i.e., which party or parties have legally enforceable rights and obligations in the contract with the supplier).

- **Step 2**: If the operator is determined to be the counterparty to the lease contract, assess if there is a sublease from the operator to the JO. To meet the requirements to recognize a sublease, an arrangement between the operator and the JO must create legally enforceable rights and obligations that convey the right to control the use of the asset to the JO.

In most cases, the operator enters into an arrangement directly with a supplier. Assuming the operator determines that it controls the use of the identified asset, the operator would recognize 100% of the right-of-use asset and lease liability to be recognized in accordance with ASC 842.

Typical JOAs will not meet the requirements to recognize a sublease because they do not create legally enforceable rights and obligations that convey the right to control the use of the asset to the JO.

In limited cases, the operator and nonoperating partners (nonoperators) will enter into a contract directly with the supplier in which the operator and nonoperators are proportionately liable for their share of the arrangement. In this case, the parties with interests in the JO would recognize their proportionate share of the leased asset, liability and rental expense when proportionate consolidation is appropriate under US GAAP.

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**Illustration 7 - Joint operations**

Upstream Co. is designated as the operator for a series of oil and gas properties in the Gulf of Mexico (GOM properties), for which there are three nonoperators. Under the JOA, the nonoperators are limited in their involvement to only making choices about participation in the exploration and development of the property.

To fulfill its responsibilities as operator, Upstream Co. contracts with Rig Co. to lease a fixed platform drilling rig (Rig A) for five years. Upstream Co. enters into the contract with the intention of using Rig A to develop the GOM properties; however, Upstream Co. does not enter into a contract with the JO (or parties to that operation) for the right to use the asset (i.e., the nonoperators do not have any legally enforceable rights and obligations with respect to Rig A).
Analysis

Upstream Co. concludes that it has legally enforceable rights and obligations with Rig Co., and that the contract represents a lease of Rig A. Therefore, Upstream Co. will record 100% of the right-of-use asset and lease liability relating to Rig A.

Upstream Co. and the nonoperators further evaluate the arrangement, noting the following:

• Upstream Co. is contractually permitted to use Rig A for projects unrelated to the joint operation, provided Upstream Co. supplies another drilling rig to fulfill its obligation as operator on the GOM properties.

• Because the nonoperators are limited in their involvement to making choices about participation in the exploration and development of the property rather than the use of the leased rig, the joint operation cannot direct the use of Rig A.

Upstream Co. determines that the arrangement with the JO does not include a sublease of Rig A. Likewise, the nonoperators determine that they are not lessees with respect to Rig A and, therefore, do not recognize any right-of-use asset or lease liability with respect to Rig A.

Related-party lease transactions

ASC 842 requires lessees and lessors to account for related-party leases (e.g., leases of assets such as pipelines or storage tanks between an entity and a related master limited partnership or equity method investee) on the basis of the legally enforceable terms and conditions of the lease. This eliminates the requirement in ASC 840 for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting.

Lessees and lessors are required to apply the disclosure requirements for related-party transactions in accordance with ASC 850, Related Party Disclosures.

Regulated operations

Entities subject to rate regulation should first apply ASC 842 and then consider whether differences from regulatory accounting may affect the recognition and subsequent measurement of regulatory assets and liabilities under ASC 980.

Transition

Refer to our ASC 842 FRD for transition guidance.

Land easements

The FASB amended the standard to provide an optional transition practical expedient that permits an entity to continue applying its current policy for accounting for land easements that existed as of, or expired before, the effective date of ASU 842. An entity that elects the practical expedient will apply it to all of its existing or expired land easements that were not previously assessed under ASC 840. Entities that elect the practical expedient will still need to evaluate whether land easements entered into or modified on or after the effective date meet the definition of a lease under ASC 842. The amendment also clarifies that for all land easements not subject to the optional practical expedient, an entity will evaluate whether land easements are leases under ASC 842 before applying the intangible assets guidance in ASC 350-30. This guidance has the same effective date and transition requirements as ASC 842.
Next steps

• Entities will have to develop new processes, controls and/or systems to identify a complete population of leases and gather information necessary to perform the accounting and make the disclosures required by the standard.

• Implementation of the new standard should involve cross-functional teams that include personnel with knowledge of how lease contracts are initiated and monitored across the entity.

• Securities and Exchange Commission (SEC) registrants should provide disclosures about the effects of the new leases standard on the financial statements as required by Staff Accounting Bulletin Topic 11.M. The SEC staff expects a registrant’s disclosures to evolve and become more specific as the effective date of a standard approaches and the registrant makes progress in its implementation plan.

Endnotes:

1 The standard is effective for public business entities and certain not-for-profit entities and employee benefit plans for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities.

2 Accounting Standards Codification (ASC) 842, Leases.


4 ASC 842-10-15-1.


6 ASC 842-40-55-8 through 10.

7 810-10-45-14 states: “An entity is in an extractive industry only if its activities are limited to the extraction of mineral resources (such as oil and gas exploration and production) and not if its activities involve related activities such as refining, marketing, or transporting extracted mineral resources.”
Appendix A: How to determine whether an arrangement is or contains a lease

The following flowchart is included in ASC 842’s implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease. Refer to our ASC 842 FRD for further guidance on these topics.

Start

Is there an identified asset? Consider paragraphs 842-10-15-9 through 15-16.

Yes

Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use? Consider paragraphs 842-10-15-17 through 15-19.

No

Yes

Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use? Consider paragraphs 842-10-15-20(a) and 842-10-15-24 through 15-26.

Neither; how and for what purpose the asset will be used is predetermined

Yes

The contract contains a lease.

No

The contract does not contain a lease.