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Lease Component, Non-Lease Component, Non-Component

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The initial and subsequent measurement guidance in Financial Accounting Standards Board *Accounting Standards Codification* (FASB ASC) 842, *Leases*, applies only to lease components. So, after determining that a contract is or contains a lease, the lessee will need to identify the separate lease and non-lease components within the contract. A lease component is the right to use an underlying asset that meets the definition of a lease. A non-lease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. Activities that are administrative in nature, such as setting up the contract or initiating the lease and reimbursement or payment to the lessor for its costs do not provide a transfer of a good or service to a lessee and do not represent separate components of the lease contract; in other words, they are non-components. In this report, we will examine how each of these (lease components, non-lease components, and non-components) are identified and their impact on the lessee's accounting.

Lease Components

A lease component is the right to use an underlying asset (or the right to use multiple underlying assets) that meets the definition of a lease. However, a lease contract may contain multiple lease components. For example, an entity may lease a warehouse, which includes a building, land, and equipment. An entity must consider whether to account for these various lease components separately or as one under FASB ASC 842. This evaluation centers on two criteria that must be met to account for a lease component separately from other lease components in a contract:

1. The lessee can benefit from the right to use the underlying asset either on its own or with other "readily available" resources
2. The right to use the underlying asset is neither highly dependent on, nor highly interrelated with, rights to use other underlying assets in the contract

CPEA Observation

The criteria above may look familiar—they are very similar to the criteria in FASB ASC 606, *Revenue from Contracts with Customers*, related to performance obligations. In the Basis for Conclusions of Accounting Standards Update (ASU) 2016-02, *Leases*, the FASB noted that the identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer (or a lessee) is contracting for a number of separate outputs (rights of use in the case of leases) or, instead, contracting for a single output that incorporates a number of different inputs. Therefore, the criteria should be applied in a similar manner.

For purposes of the first criterion, the lessee should focus on whether an underlying asset can be used on its own, or whether using the asset requires other inputs or interfacing with other assets. FASB ASC 842 describes "readily available resources" as goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).

For purposes of the second criterion, the lessee should focus on whether each right-of-use (ROU) significantly affects the others. The following example is adapted from FASB ASC 842-10-55 and illustrates how a lessee would apply these criteria in a contract to use construction equipment.

Example 1 – Identifying Separate Lease Components

Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. Lessee concludes that the leases of the bulldozer, the truck, and the crane are each separate lease components because both of the criteria above are met:

a. Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or crane to use with the bulldozer).
b. Despite the fact that Lessee is leasing all three machines for one purpose (that is, to engage in construction operations), the machines are not highly dependent on or highly interrelated with each other. The machines are not, in effect, inputs to a combined single item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations, and Lessee's ability to derive benefit from the lease

of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from Lessor.

If a right to use an underlying asset does not meet the two criteria for separation, it must be combined with another ROU, so that the combined ROU meets both criteria. The combined right of use ROU is then accounted for as a single lease component.

Practice Note

FASB ASC 842 also requires an entity to account for a right to use land as a separate lease component, even if the separation criteria above are not met, unless the accounting effect of doing so would be insignificant (e.g., separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant). The FASB decided that land, by virtue of its indefinite economic life and non-depreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met. Importantly, the guidance for leases involving land under FASB ASC 842 differs from the legacy guidance for leases in FASB ASC 840, Leases, involving land and buildings that do not meet the legacy transfer-of-ownership or bargain-purchase-option classification criteria. Under FASB ASC 840-10-25-38(b), if the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessee would combine the land and the building and account for them as a single lease component. Under the new guidance in FASB ASC 842-10-15-29, this expedient is no longer available. An entity leasing land and other assets must account for the right to use land as a separate lease component, unless doing so would have an insignificant effect on the accounting.

Non-Lease Components

Service contracts, maintenance, and repair costs are frequently associated with owning and operating an asset. Often, for convenience, these costs are embedded in the periodic payments made by the lessee. This raises the question of whether these costs should be treated as separate components of the lease contract or, instead, capitalized as part of the ROU asset. The determining factor is whether the cost represents a transfer of a good or service to the lessee apart from the leased asset. If so, it would be treated as a non-lease component and is separated from the lease payments.

CPEA Observation

FASB ASC 840 required an entity to separate non-lease components but provided limited guidance on how to make those separations. In addition, the distinction was typically of limited financial reporting consequence for current operating leases, since operating leases are not capitalized. However, under FASB ASC 842, with operating leases capitalized and services not capitalized, segregated lease and non-lease components will have a significant financial reporting consequence.

FASB ASC 842-10-55-33 also indicates that warranties provided by the lessor should be evaluated. Generally, warranties with respect to the performance of the underlying asset or to effectively protect the lessee from obsolescence of the underlying asset are not considered non-lease components. However, if the lessor's commitment is more extensive than a typical product warranty, it might indicate that the commitment is providing a service to the lessee that should be accounted for as a non-lease component.

Practical Expedient

When a contract includes both lease and non-lease components, the lessee either: (a) separates the lease components from the non-lease components or (b) elects an accounting policy by class of underlying asset to not separate non-lease components from lease components and, instead, to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.

Practice Note

Although FASB ASC 842 allows a lessee to make an accounting policy election by class of underlying asset, to not separate non-lease components from lease components, the result of electing this practical expedient will be to record a larger ROU asset and lease liability.

Non-Components

Components of a contract include only those items or activities that transfer a good or service to the lessee. In other words, these "non-components" do not provide an additional good or service to the lessee. The following are common examples of non-components:

- Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee

- Real estate or property taxes related to the leased asset
- Insurance that covers the lessor's interest in the asset
- Reimbursement or payment of the lessor's costs
- Shipping, delivery and installation of the underlying asset
- Commitment fees

CPEA Observation

A lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset. A non-component cannot be a unit of account. As such, no contract consideration is allocated to non-components.

Allocation to Lease and Non-Lease Components

FASB ASC 842 requires the lessee to allocate the consideration in the contract to the separate lease components and the non-lease components based on the standalone prices of the lease and non-lease components.

Practice Note

As indicated in an FASB memo related to a September 2020 public roundtable on leases implementation, the guidance on lessee allocation of contract consideration is not intuitive to many lessees and practitioners. Some may be recognizing lease and nonlease components solely in accordance with stipulated terms of a contract, primarily because it is intuitive to them to do so (resulting in noncompliance with FASB ASC 842). Additionally, many lessees may elect the practical expedient to combine components and account for the combined component as a lease component to avoid what they consider to be an arduous allocation process.

If observable standalone prices are available, they should be used for allocation purposes. Observable standalone price is defined as the price that the lessor or other suppliers would charge if they sold the components separately to a customer. The best evidence of that price is if the lessor has separate actual sales to customers of a similar good or service. This approach also may include using prices from other suppliers for similar goods or services and adjusting those prices as needed. If the standalone price for a component has a high level of variability or uncertainty, the residual estimation approach may be appropriate.

CPEA Observation

The lessee will need to reallocate the consideration in the contract either (1) on remeasurement of the lease liability (e.g., a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset), or (2) at the effective date of a contract modification that is not accounted for as a separate contract.

If the lease includes variable payments, those payments will need to be allocated to the lease and non-lease components in the period that the obligation to make those payments is incurred. That allocation is made in the same way as the initial allocation of the consideration in the contract. Importantly, the allocation of total fixed payments and variable payments is made in that way regardless of what the contract terms stipulate (i.e., what component has a fixed payment and what component has variable payment). In other words, the amount of the allocation is based on the standalone selling prices; the timing of when the allocation occurs depends on whether the payments are fixed or variable.

Practice Note

Guidance on this topic for lessees is in the implementation section of FASB ASC 842 and is limited to Example 14, Case A & B. FASB ASC 842-10-55-154 indicates that, even when variable payments in a contract related specifically to specialized maintenance services, the allocation of payments must be made in the same way as the initial allocation of the consideration in the contract. In this Case (as you would expect in other similar cases), an allocation of the variable payment contractually related to the specialized maintenance services must be made to the lease component.

Example 1:

Assume that a lease contract stipulates the total fixed payments in the contract are $10,000 per year for 10 years or $100,000 and those payments relate entirely to the lease component. The fixed payments are considered commensurate with market prices. The contract also stipulates maintenance services will be provided on that asset (the non-lease component) and will be billed annually at a market-based rate (variable payments). Regardless of what is stipulated, the Lessee would have to (a) determine standalone prices for the lease component and the non-lease component and (b) allocate a portion of both the fixed payments and the variable payments (when incurred) to the lease and non-lease components on a relative standalone basis. Because the lease component is commensurate with market prices, its standalone selling price is $100,000. Assume that the Lessee estimates that the standalone selling price of the service component (non-lease component) is $10,000. Assume the lease is an operating lease.

a. For the fixed payments, $91,000 would be used as the basis for the lease liability (before discounting) and $9,100 of lease cost would be recognized annually on a straight-line basis for 10 years. Assuming that the Lessee recognizes the maintenance services on a straight-line basis throughout the lease term, it will recognize $900 of maintenance expense per year.
b. For the variable payments, assume that Lessee incurs the obligation to make variable maintenance payments at the end of each year. At the end of Year 1, $1,000 of maintenance services are charged by the Lessor to the Lessee. The Lessee will allocate 91 percent or $910 to lease cost and 9 percent or $90 to maintenance expense.

So, in total for Year 1, the Lessee would allocate $10,010 to lease cost and $990 to maintenance expense. Many will be tempted to assume that the contractually stipulated amounts of $10,000 would be allocated to lease cost and $1,000 to maintenance expense. As indicated in the FASB memo, to avoid this complexity, a high percentage of current adopters of FASB ASC 842 elected the practical expedient to combine lease and non-lease components.

Practice Note

If the lessee elects the practical expedient, all payments, fixed and variable, would be treated as lease payments. This results in the fixed payments in a contract being solely attributed to the lease component, resulting in a larger lease liability than if the components were separated and a portion of the fixed payments were allocated to the non-lease component. A lessee electing this expedient also would account for variable payments as lease expense in their entirety in the period that the obligation to make the lease payment is satisfied. As a result of electing the practical expedient, the entity also would disclose all variable payments as variable lease payments even though they were contractually stipulated to be related to maintenance.

The following example is adapted from example 14 in paragraphs 150- of FASB ASC 842-10-55 and illustrates how a lessee would treat fixed and variable consideration with lease and non-lease components.

Example 2:

Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (i.e., the equipment is not malfunctioning or inoperable). The potential $7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity. The lease is an operating lease.

The consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of $100,000 each year (or $300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are $285,000 and $45,000, respectively.

Component	Standalone Price	Standalone Price Relative to Total of Standalone Prices	Allocated Contract Consideration
Lease	$285,000	86.4%	$259,091
Maintenance	45,000	13.6%	40,909
Total	$330,000	100%	$300,000

Each $100,000 annual fixed payment and each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (i.e., 86.4 percent to the equipment lease and 13.6 percent to the maintenance services). Therefore, annual lease expense, excluding variable expense, is $86,364 ($259,091 / 3 years). The variable payments would be recognized as a service expense as the obligation is incurred.

Note that, even if the maintenance services were almost certain to be incurred, Lessee would account for the potential variable payments in the same manner as above.

Practice Note

The seemingly "non-intuitive" accounting for contracts with lease and non-lease components that have both fixed and variable payments (where the practical expedient to combine lease and non-lease components is NOT elected) was a topic for discussion at the FASB September 2020 lease roundtable. Various alternatives were suggested to improve the accounting. Practitioners should monitor standard setting activity for further developments in this area.

<u>Comprehensive Example</u>

The following comprehensive example, derived from FASB ASC 842-10-55, illustrates how to identify lease components, non-lease components, and non-components and allocate contract consideration:

Case A:

Lessor leases 100,000 square feet of an office building to Lessee for five years. Lessor did not give Lessee any lease incentives and there are no renewal or termination options. Lessee will pay $300,000 per year to lease the space. Assume that the contract meets the definition of a lease and that the lease term is five years. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the Lessee is. Lessor is the named insured on the building insurance policy (i.e., the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at $300,000 per year in advance, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year.

In this case, the real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component—the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. Assume the rate implicit in the lease is not readily determinable and, therefore, Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the lease payments of $1,500,000 (5 payments of $300,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,363,785. Because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized by Lessee as a current period expense when paid.

Case B:

Assume the same facts and circumstances as in Case A, except that the fixed annual lease payment is $357,000. There are no additional payments for real estate taxes or building insurance; however, the fixed payment is itemized in the contract (i.e., $312,000 for rent, $35,000 for real estate taxes, and $10,000 for building insurance). As in Case A, the taxes and insurance are not components of the contract. The contract includes a single lease component—the right to use the building. The $1,785,000 in payments Lessee will make over the 5-year lease term are all lease payments for the single component of the contract and, therefore, are included in the measurement of the lease liability. Assume the rate implicit in the lease is not readily determinable and, therefore, Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,622,904.

Case C:

Assume the same facts and circumstances as in Case B, except that the fixed annual lease payment of $357,000 also covers Lessor's performance of common area maintenance activities (CAM) (e.g., cleaning of common areas, parking lot maintenance, and providing utilities to the building). Lessee also paid $10,000 in real estate commissions and legal costs related to the lease negotiation. Assume that these fees meet the definition of an initial direct cost.

Consistent with Case B, the taxes and insurance are not components of the contract. However, the CAM is a component because Lessor's activities transfer services to Lessee. That is, Lessee receives a service from Lessor in the form of the CAM activities it would otherwise have to undertake itself or pay another party to provide (e.g., cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities). The CAM is a single component in this contract rather than multiple components because Lessor performs the activities as needed (e.g., plows snow or undertakes minor repairs when and as necessary) over the same period of time.

The contract consideration equals $1,785,000, as follows:

	Annual Payment	Total over Lease Term
Fixed lease payment	$300,000	$1,500,000
Property taxes	35,000	175,000
Building insurance	10,000	50,000
CAM	12,000	60,000
Total contract consideration	$357,000	$1,785,000

Case C1:

Assume that Lessee separately accounts for the lease and non-lease components. The following table lists the components, the standalone prices for each component, and the contract consideration and initial direct costs allocated to each component. Based on research by Lessee, the standalone prices are observable prices charged by other lessors for similar office space and suppliers of similar CAM.

Component	Standalone Price	Standalone Price Relative to Total of Standalone Prices	Allocated Contract Consideration	Allocated Initial Direct Costs
Lease (right to space in the building)	$1,750,000	95%	$1,695,750	$9,500
Non-lease (CAM)	92,105	5%	89,250	500
Total	$1,842,105	100%	$1,785,000	$10,000

Assume the rate implicit in the lease is not readily determinable and, therefore, Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the allocated unpaid lease payments of $1,695,750 (5 payments of $357,000 x 95%), discounted at 5%, to arrive at the lease liability initial measurement of $1,541,759.

Lessee’s initial measurement of its ROU asset is $1,551,259, calculated as follows:

Lease liability ($1,541,759) + Initial direct costs ($9,500) + Prepaid lease payments (none) – Lease incentives received (none)

The $89,750 ($89,250 of contract consideration and $500 of initial direct costs) allocated to the non-lease component (CAM) are recognized as a service expense over the 5-year term of the lease.

CPEA Observation

The amount billed for the right to the space ($1,500,000) and the CAM ($60,000) is NOT the same as the consideration allocated. Practitioners may be tempted to shortcut the allocation process by using stated amounts for billing in a contract, this is not appropriate, and differences may need to be quantified.

Case C2:

Now, assume that Lessee elects the accounting policy to not separate each lease component from the non-lease components related to it. In this case, there is only one unit of account, which includes both the right to use the space in the building and the CAM. In this case, Lessee determines its lease liability by calculating the present value of the unpaid lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability initial measurement of $1,622,904.

Lessee's initial measurement of its ROU asset is $1,632,904, calculated as follows:

Lease liability ($1,622,904) + Initial direct costs ($10,000) + Prepaid lease payments (none) – Lease incentives received (none).