

## Identifying embedded leases for private companies

Are leases hiding in your contracts?



When it comes to ASC 842<sup>1</sup> compliance, the challenges related to accounting for known leases may be grabbing headlines, but identifying contracts that contain embedded leases could add another level of difficulty for private companies.

While the definition of a lease under the new standard is not much different than under ASC 840<sup>2</sup>—and the requirement to search for embedded leases is not new—the financial statement impact of failing to appropriately identify a lease can be more significant under ASC 842. Under ASC 840, operating leases and service contracts that may have contained leases were expensed in a similar fashion. As a result, private companies may not have been rigorous about identifying embedded leases.

The FASB's new lease standard, however, requires many<sup>3</sup> leases to be recorded on the balance sheet, which represents a big change in financial reporting. The rules are expected to have an impact on private companies in many industries. From manufacturing to telecommunications and financial services to pharmaceuticals, nearly all organizations enter into lease arrangements. The new lease accounting rules go into effect for private companies in 2021.

The phrase “embedded leases” may sound daunting or confusing, but the concept is straightforward: Embedded leases are leases contained within larger arrangements.

### Where could your leases be hiding?

#### Common areas for embedded leases:



Information technology contracts (e.g., servers)



Transportation and delivery services (e.g., railcars)



Contract manufacturing arrangements (e.g., dedicated tooling)



Complex service contracts (e.g., specified equipment)



Cable and satellite services (e.g., set-top boxes)



Advertising (e.g., billboards)



Power purchase arrangements (e.g., power plants)



Joint-operating agreements (e.g., drilling rigs)

## Not every lease says “lease” on the cover or is a lease in legal form

Identifying and collecting the contracts that may contain embedded leases can be tricky because all contracts that meet the accounting definition of a lease will likely not be labeled as such. A contract is, or contains, a lease if it conveys the right to control the use of a specified asset (e.g., plant, property, and equipment) over a period in exchange for consideration. It is not uncommon for service contracts to convey to the customer the right to use a specified asset during the contract term.

For example, a private company enters into a contract to advertise on a billboard. Although this contract could be written as an advertising service contract, the right to use the billboard may meet the definition of a lease. Or a private company could enter into an arrangement with an information technology organization to host its data on a dedicated server. Embedded within this IT hosting arrangement may be the company's right to direct the use of a specified server, which may meet the definition of a lease.

Although it is possible that some of these contracts may not meet all aspects of the lease definition after considering the specific terms, it is critical that private companies engage in a thoughtful analysis to identify and document contracts that may contain embedded leases. Consider consulting with your accounting advisors to help ensure you perform this analysis appropriately, as it can involve significant judgment. Chapter 3 of Deloitte's [A Roadmap to Applying the New Leasing Standard](#) contains additional examples and considerations that may help inform your analysis.

## Identifying embedded leases

Many private companies currently have contracts that contain embedded leases. Identifying these contracts and properly accounting for them requires a diligent approach. Leading practices include:

 **Look closely at all operations.** Meet with relevant departments to understand the type of service contracts that exist, and discuss the specific concepts of the ASC 842 definition of a lease. Translate the technical concepts of the rules into language that non-accountants will likely understand. For example, rather than asking if contracts may contain embedded leases, ask whether any service contracts involve the use of specific assets as part of the service delivery. Surveys also provide a useful tool for identifying embedded leases.

 **Assess areas of risk.** Perform a risk assessment to identify areas where embedded leases are more likely to exist. Consider the financial statements contractual commitment footnote as a starting point for the assessment. Does your organization contract with third parties to manufacture a specialized product line? Is your company subject to regulations (e.g., Food and Drug Administration regulations or the Health Insurance Portability and Accountability Act) that may require dedicated equipment? Do you lease property that includes a maintenance contract?

 **Review expense activity.** Evaluate general-ledger expense activity to identify expenses that require analysis. Payments that recur on a monthly or quarterly basis may signal a need for review.

 **Perform a physical inspection.** Walk through offices or manufacturing locations to identify leased assets that might not appear on an asset listing or registry, such as a large-format printer or medical testing device.

 **Examine contracts.** Ask the legal department to help review and identify contracts that should be evaluated.

## Uncovering the embedded lease: real-world examples

 **Railcars:** A company enters into an arrangement to transport goods using a fleet of railcars. The transportation contract contains an embedded right to use the cars during the period of the transportation contract.

 **Contract manufacturing:** A large retailer contracts with an entity to manufacture shoes for the retailer. The contract is so large that the manufacturer has a specific facility that only manufactures shoes for the retailer. The contract manufacturing arrangement contains an embedded lease for the physical manufacturing space and equipment used to produce the shoes.

 **IT services:** A hospital subject to HIPAA regulations engages an IT service provider to provide cloud-computing services. To ensure that patient privacy rights are not violated, the contract requires a single dedicated server be used to provide the services. The hospital decides when and how the dedicated server is used based on its instructions to the IT service provider. The contract contains an embedded lease of the dedicated server.

## Ongoing accounting considerations

Outside of the implementation effort, organizations will likely need to make changes to processes and internal controls to be sure they can identify contracts that could contain embedded leases going forward. They should also consider how they will capture information that may trigger reassessment (and remeasurement) or modification of existing contracts that contain embedded leases.

## Let's talk

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Searching for embedded leases can be an extensive process, which you may not have initially planned for as part of your ASC 842 implementation efforts. For more information about how to conduct a thoughtful and efficient search for embedded leases under the new standard, contact:



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For additional ASC 842 guidance, refer to Deloitte's [A Roadmap to Applying the New Leasing Standard](#).

- 1 Accounting Standards Codification 842 Leases ("ASC 842"), issued by the Financial Accounting Standards Board (FASB) as Accounting Standards Update 2016-02.
- 2 Accounting Standards Codification 840 Leases ("ASC 840"), issued by the Financial Accounting Standards Board (FASB) as Accounting Standards Update 2016-02.
- 3 Lessees can elect an accounting policy, by class of underlying asset, not to record short-term leases on the balance sheet.

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