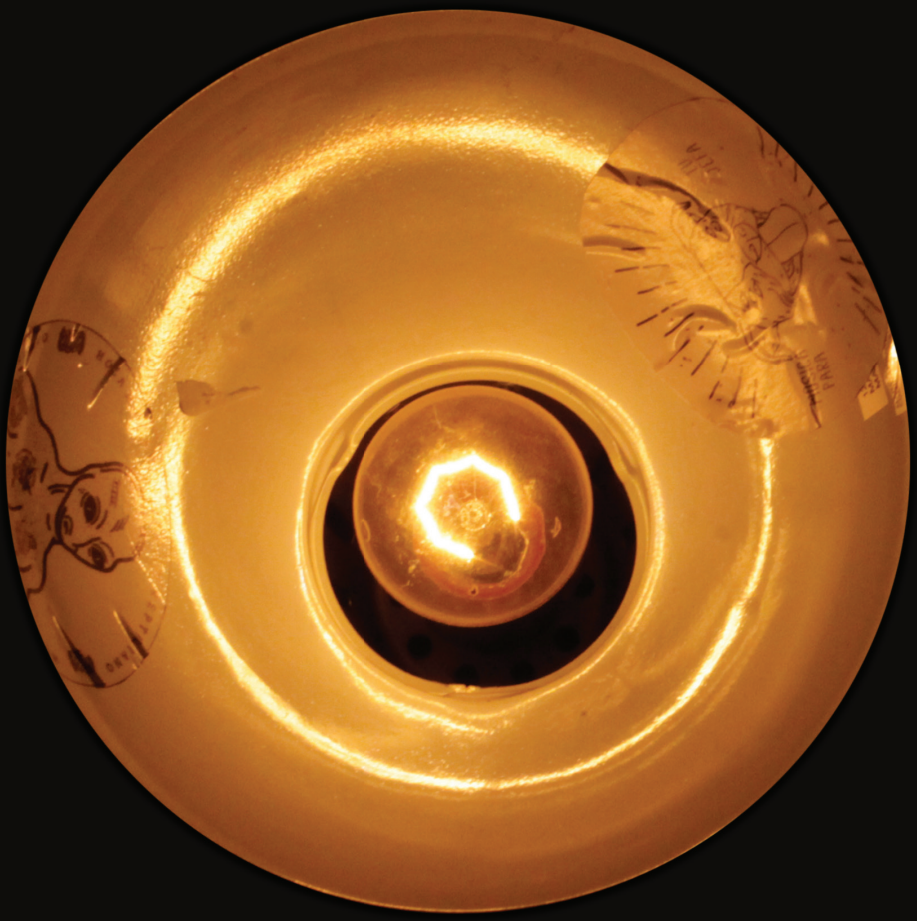
Deloitte.



Power & Utility Companies

Deloitte Lease Accounting and Risk Advisory Services

September 2019

The Bottom Line

- The Financial Accounting Standards Board (FASB) issued ASU 2016-02,[1] its final standard on leases, on February 25, 2016, and the International Accounting Standards Board (IASB) issued its final standard, IFRS 16,[2] on January 13, 2016. The primary objective of the leases project was to address the current off-balance-sheet financing concerns related to a lessee's operating leases.
- When entities are determining whether a contract is or contains a lease under the new standard, they will need to assess whether (1) performance of the contract depends on the use of an identified asset and (2) the customer obtains the right to control the use of the identified asset for a particular period. Control of the right to use an identified asset under ASC 842 is different from the assessment that is required under today's guidance and therefore may affect the determination of whether an off-take arrangement (e.g., a power purchase agreement (PPA)) is a lease.
- Although the FASB and IASB (collectively, the Boards) agreed to bring most leases onto the balance sheet for lessees and reached agreement on a lessee's initial measurement of the related assets and liabilities, the Boards differed on the lessee's subsequent measurement. The FASB decided on a dual-model approach, while the IASB will require a single-model approach.
- The renewable energy sector may see significant changes and experience challenges as a result of ASC 842, particularly in an entity's determination of whether the contract is or contains a lease (e.g., in the assessment of the impact of involvement in the generating asset's design and in the determination of how to evaluate certain rights that affect the operation of the generating asset).
- The new standard, which is effective for calendar periods beginning January 1, 2019, for public business entities (PBE)[3] and January 1, 2021[4], for all other entities, represents a significant change to lease accounting, and as a result, entities will likely face significant implementation challenges during the transition period and beyond.
- As part of Deloitte's Roadmap Series, *A Roadmap to Applying the New Leasing Standard* is available in both electronic and print formats, and is designed to serve as a detailed resource and in-depth technical guide for entities adopting ASC 842.

1 FASB Accounting Standards Update No. 2016-02, *Leases*. The ASU supersedes FASB Accounting Standards Codification (ASC) Topic 840, *Leases*, and creates ASC 842, *Leases*. For titles of additional ASC references, see Deloitte's "*Titles of Topics and Subtopics in the FASB Accounting Standards Codification*."
2 The IASB issued IFRS 16, Leases, on January 13, 2016. For more information on the IASB's standard, see Deloitte's January 13, 2016, *IFRS in Focus*.
3 At the July 20, 2017, EITF meeting, the SEC staff announced it would not object when certain PBEs elect to use the non-PBE effective dates to adopt the new leasing standard. The ability to use non-PBE effective dates is limited to the subset of PBEs that otherwise would not meet the definition of a public business entity except for a requirement to include or inclusion of its financial statements or financial information in another entity's filings with the SEC.
4 At its July 17, 2019, Board meeting, the FASB tentatively decided to change the manner in which it staggers effective dates for major standards and to amend the effective dates in some of its recently issued or amended major Accounting Standards Updates to give implementation relief to certain types of entities. Specific to the new leasing standard, the FASB deferred the effective date by one year for non-PBEs.

Overview of the New Standard

Background

In February 2016, after working with the IASB on a joint leases project for almost a decade, the FASB finally issued its new standard on accounting for leases, ASU 2016-02. The leases project's primary objective was to address the off-balance-sheet financing concerns related to lessees' operating leases. Accordingly, the FASB's new standard introduces a lessee model that brings most leases onto the balance sheet. In addition, the standard aligns certain underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those that help entities evaluate how collectability should be considered and determine when profit can be recognized). The ASU also addresses other concerns related to the current leases model, which is almost 40 years old. For example, the new standard eliminates the requirement that entities use bright-line tests to determine lease classification. The standard also requires lessors to be more transparent about their exposure to risks regarding the changes in value of their residual assets and about how lessors manage that exposure.

The changes introduced by the new leases standard are effective January 1, 2019, for public companies and may significantly affect entities in the P&U industry because of their extensive use of fixed assets under contracts that may qualify as leases under the new guidance. P&U entities often enter into agreements that are frequently customized and include services and other components critical to completing the contracts. While under current guidance the accounting for operating leases is often similar to that for service contracts, this will no longer be the case under the new standard. The FASB has stated its concern that existing contracts that meet the definition of a lease under both ASC 840 and ASC 842 may not have historically been identified as leases, likely because the accounting for operating leases under ASC 840 is often similar to that of service contracts, and as such, less scrutiny was used in lease identification. Therefore, entities should carefully evaluate the completeness of their population of contracts, or portions thereof, that meet the new definition of a lease.

Scope

Like the scope of the current guidance on leases, the scope of the new guidance is limited to leases of PP&E. The scope excludes (1) leases of intangible assets; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets; (4) leases of inventory; and (5) leases of assets under construction.

Connecting the Dots

The FASB decided to include guidance on a lessee's control of an underlying asset that is being constructed before lease commencement. That is, if a P&U entity that is involved in the construction of PP&E it intends to lease is determined to control the asset during the construction period, it will be considered the owner of the construction work in progress (CWIP) for accounting purposes and will need to assess the arrangement under the new standard's sale-leaseback guidance once construction is completed.

In addition, questions have arisen about whether pole attachments and easements or rights-of-way would or could be within the scope of the new standard. See our discussion of pole attachments and easements in the Implications for P&U Entities section below.

Definition of a Lease

Identified Asset

The new standard defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." Control is considered to exist if the customer has both of the following:

- The "right to obtain substantially all of the economic benefits from the use of [an identified] asset."
- The "right to direct the use of the [identified] asset."

The notion of an identified asset is mostly consistent with that in current US GAAP. Under this concept, a leased asset must be identifiable either explicitly (e.g., by a named generating asset) or implicitly (e.g., the asset is the only one available to meet the requirements of the contract). A specified asset can also be a physically distinct portion of a larger asset (e.g., one floor of a building). However, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a natural gas pipeline's or storage facility's total capacity) will generally not be a specified asset unless that capacity portion represents substantially all of the larger asset's overall capacity.

The evaluation of whether there is an identified asset also depends on whether a supplier has a substantive substitution right throughout the period of use. Substitution rights are considered substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use (e.g., the customer cannot prevent the supplier from doing so, and alternative assets are readily available to, or can be quickly sourced by, the supplier), and the supplier could benefit economically from the substitution.

An entity uses significant judgment when determining whether a substitution right is substantive. The entity should consider the facts and circumstances at the inception of the contract and exclude from its assessment circumstances that are not likely to occur over the contract term. The entity should also consider the asset's physical location. For example, it is more likely that the supplier will benefit from the substitution right if the identified asset is located at the supplier's rather than at the customer's premises (because the costs of substituting the asset may be lower). It may be difficult for a customer to determine whether the supplier's substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit. A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise.

Connecting the Dots

The requirement that a substitution would provide an economic benefit to the supplier is a higher threshold than that in current US GAAP. Accordingly, we expect more arrangements to be subject to lease accounting by virtue of the new standard's changes to the evaluation of substitution rights.

Convey the Right to Control the Use

With regard to a customer's right to control the use of the identified asset, the definition of a lease under the new standard represents a significant change from previous guidance. Under current US GAAP, an entity's taking substantially all of the outputs of an identified asset was considered indicative of the customer's right to control the use of that asset if the pricing per unit in the arrangement was neither fixed nor equal to the market price per unit at the time of delivery (e.g., a PPA in which the off-taker purchases substantially all of the outputs of a generating asset).

By contrast, the new standard aligns the assessment of whether a contract gives the customer the right to control the use of the specified asset with the concept of control developed as part of the FASB's new revenue standard. Accordingly, a contract evaluated under the new leases standard is deemed to convey the right to control the use of an identified asset if the customer has both the right to direct, and obtain substantially all of the economic benefits from, the use of that asset. The right to direct the use of the specified asset would take into account whether the customer has the right to determine—or predetermine—how and for what purpose the asset is used. Economic benefits from the use of the specified asset would include its primary products and by-products or other economic benefits that the customer can realize in a transaction with a third party (e.g., renewable energy credits).

Connecting the Dots

In determining whether a lease exists under the new standard, an entity would emphasize its ability to direct the use of the asset. This guidance is significantly different from today's model, under which a lease can exist on the basis of the level of output taken by the customer, and, therefore, we expect fewer off-take arrangements to be leases in the P&U industry. Dispatch rights held by an off-taker will generally convey control; however, off-take arrangements with predefined delivery schedules or weather-driven production may not meet the control requirement. To help illustrate the factors for an entity to consider when evaluating whether a contract is or contains a lease, the final standard provides three examples that apply to the P&U sector (see ASC 842-10-55-108 through 55-123).

Lessee Accounting Model

Initial Measurement

The initial measurement of a lease is based on a right-of-use (ROU) asset approach. Accordingly, once the standard is effective, **all** leases (finance and operating leases) other than those that qualify for the short-term lease exception must be recognized as of the lease commencement date on the lessee's balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments based on usage or performance), and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset will also include (1) initial direct costs (e.g., legal fees, consultant fees, commissions paid) that are incremental costs of a lease that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or as of the commencement of the lease. The ROU asset will be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor will reduce the ROU asset).

In addition to those payments that are directly specified in a lease agreement and fixed over the lease term, lease payments include variable lease payments that are considered in-substance fixed payments (e.g., when a variable payment includes a floor or a minimum amount). However, the fact that a variable lease payment is virtually certain (e.g., a variable payment for highly predictable output under a renewable PPA) does not make the payment in-substance fixed. Therefore, it will not be included in the determination of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Connecting the Dots

PPAs for the output of a wind farm may include payment terms that are 100 percent contingent on production. The wind farm developer may undertake an engineering production case to support the wind farm's expected annual energy output at a particular level (e.g., 95 percent probability, or P95 production level). Although the off-taker from the wind farm may consider the expected P95 production to indicate a relatively fixed or minimum amount of annual delivered energy, that expected amount is contingent (i.e., if the wind does not blow, payment will be zero). Therefore, the expected amount in this case would not constitute an in-substance fixed lease payment. Some renewable PPAs provide for a guaranteed minimum production level to give the buyer price certainty over a minimum volume of electricity and to facilitate compliance with renewable portfolio standards. In general, we would not expect such provisions to establish a fixed lease payment obligation, since these provisions typically settle financially with a payment to the off-taker (e.g., current market price of power multiplied by volume shortfall) and therefore do not establish a minimum obligation on the part of the off-taker. In other words, it is not possible to guarantee physical output from these facilities, given their dependence on weather, and these provisions are designed to protect the off-taker from the financial burden of buying replacement power, not to ensure a minimum level of revenue for the seller. Note that this concept holds true for other renewable energy power-generating facilities (e.g., solar farms) as well.

In contrast to usage-based variable payments described above, we believe that capacity payments under PPAs generally represent fixed payments and therefore should be included in lease payments for classification and measurement purposes. While capacity payments are technically at risk (that is, they are often subject to clawback or refund if the generating unit has an unplanned outage), we believe that there is a premise in lease accounting that the asset is ready for its intended use and therefore capacity payments should be deemed fixed. In a scenario in which capacity payments are refunded to a customer because of an unplanned outage, we would expect those to be treated as negative variable payments (akin to negative contingent rents under ASC 840) in the period incurred.

Subsequent Measurement

The FASB decided in the ASU to maintain a dual-model approach, in which a lessee classifies the lease on the basis of whether the control of the underlying asset is effectively transferred to the lessee (e.g., substantially all the risks and rewards incidental to ownership of the underlying asset are transferred to the lessee). Lessees would classify a lease as either a finance lease or an operating lease by using classification criteria similar to those in IAS 17.

Therefore, lessees will classify a lease as a finance lease if any of the criteria below are met at the commencement of the lease4:

- "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 the major part of the remaining economic life of the underlying asset."5
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . 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."

4 Quoted text is from ASC 842-10-25-2.

5 The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

An entity determines the lease classification at lease commencement and is not required to reassess its classification unless (1) the lease is subsequently modified and the modification is not accounted for as a separate contract or (2) there is a change in lease term or a change in the assessment of the exercise of a purchase option.

Connecting the Dots

The FASB adopted the dual-model approach on the premise that all leases are not created equal. That is, some leases are more akin to an alternate form of financing for the purchase of an asset, while others are truly the renting of the underlying property.

While the ASU's classification criteria are similar to those in IAS 17, they vary from the current requirements in US GAAP (i.e., the specific quantitative thresholds have been removed, and a fifth criterion, which does not exist under ASC 840, has been added). As a result, a lease that would have been classified as an operating lease under ASC 840 may be now classified as a finance lease under the ASU. In addition, as a reasonable approach to assessing significance, an entity is permitted to use the bright-line thresholds that exist under ASC 840 when determining whether a lease would be classified as a finance lease.

An entity will also assess land and other elements in a real estate lease as separate lease components under the new standard unless the accounting result of doing so would be insignificant. This approach is also similar to current guidance under IFRS but will reflect a change from that in current US GAAP, under which a lessee is required to account for land and buildings separately only when (1) the lease meets either the transfer-of-ownership or bargain-purchase-option classification criterion or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate lease components and may affect the allocation of the lease payments to the various elements.

Finance Leases

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability. The lessee will amortize the ROU asset in a manner similar to that used for other nonfinancial assets; that is, the lessee will generally amortize the ROU asset on a straight-line basis unless another systematic method is appropriate. Together, the amortization and resulting interest expense will result in a front-loaded expense profile similar to that of a capital lease arrangement under current US GAAP. Entities will separately present the interest and amortization expenses in the income statement.

Operating Leases

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset will be linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset will be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. As a result, the total lease payments made over the lease term will be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.

Connecting the Dots

While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the viewpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease. Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee's obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply "plugged" as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and the ROU asset in the balance sheet reflects a bifurcated view of the expense. Note, however, that the periodic lease cost cannot be less than the calculated interest on the lease liability (i.e., the amortization of the ROU asset, or plug amount, cannot be negative).

Regulated utilities will be pleased that the FASB carried forward the guidance that allows the timing of lease expense recognition to be consistent with the effects of rate-making. Specifically, ASC 980-842-45-1 through 45-4 state, in part, the following (emphasis added):

- 45-1: "Topic 842 specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a lease may be treated as an operating lease even though the lease would be classified as a finance lease under those criteria. In effect, the amount of the lease payment is included in allowable costs as rental expense in the period it covers."
- 45-2: "For financial reporting purposes, the classification of the lease is not affected by the regulator's actions. **The regulator cannot eliminate an obligation that was not imposed by the regulator** (see paragraph 980-405-40-1). . . . **Accordingly,**

regulated entities shall classify leases in accordance with Topic 842."

- 45-3: "The nature of the expense elements related to a finance lease (amortization of the right-of-use asset and interest on the lease liability) is not changed by the regulator's action; however, the timing of expense recognition related to the lease would be modified to conform to the rate treatment. **Thus, amortization of the right-of-use asset shall be modified so that the total of interest on the lease liability and amortization of the right-of-use asset shall equal the lease expense that was allowed for rate-making purposes."**
- 45-4: "Paragraph 842-20-45-4 states that an entity is not required to classify the interest expense and amortization of the right-of-use asset in a **finance lease** as separate items in an income statement. For example, the amounts of amortization of the right-of-use asset and interest on the related lease liability could **each** be combined with other costs and presented in a manner consistent with how the entity presents depreciation or amortization of similar assets and other interest expense."

The above paragraphs clarify that although an entity can treat a finance lease as an operating lease for rate-making purposes, this does not override the classification of the lease as a finance lease in accordance with ASC 842. However, a regulator's action can change the timing of expense recognition of a finance lease; that is, the total periodic lease cost (amortization of the ROU asset and interest on the lease liability) should be adjusted to represent the lease expense that was permitted for rate-making purposes. Finally, under the presentation requirements in ASC 842-20-45-4, the ratemaking treatment of the lease expense does not change the requirement that the interest on the lease liability and the amortization of the ROU asset be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of other assets, respectively. The guidance above is virtually identical to the guidance currently in ASC 980-840-45 and, accordingly, we do not expect a change in practice in this area as a result of ASC 842.

Impairment

Regardless of the lease classification, a lessee will subject the ROU asset to impairment testing in a manner consistent with that for other long-lived assets (i.e., in accordance with ASC 360). If the ROU asset for a lease classified as an operating lease is impaired, the lessee will amortize the remaining ROU asset under the subsequent measurement requirements for a finance lease—evenly over the remaining lease term unless another systematic method is appropriate. In addition, in periods after the impairment, a lessee will continue to present the ROU asset amortization and interest expense as a single line item.

Lessor Accounting

After proposing various amendments to lessor accounting, the FASB ultimately decided to keep the lessor model's classification and resulting accounting largely unchanged; however, there are certain differences between the new guidance and the previous guidance that companies should focus on during their implementation of the new leasing standard. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition requirements and amend the lease classification criteria to be consistent with those for a lessee.

Accordingly, the ASU requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, direct financing lease,6 or operating lease:

- *Sales-type lease*: The lessee effectively gains control of the underlying asset. The lessor derecognizes the underlying asset and recognizes a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). Any resulting selling profit or loss is recognized at lease commencement. Initial direct costs are recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs are deferred and recognized over the lease term. In addition, the lessor recognizes interest income from the lease receivable over the lease term.

In a manner consistent with ASC 606, if collectability of the lease payments plus the residual value guarantee is not probable, the lessor does not record a sale. That is, the lessor will not derecognize the underlying asset and will account for lease payments received as a deposit liability until (1) collectability of those amounts becomes probable or (2) the contract has been terminated or the lessor has repossessed the underlying asset. Once collectability of those amounts becomes probable, the lessor derecognizes the underlying asset and recognizes a net investment in the lease. If the contract has been terminated or the lessor has repossessed the underlying asset, the lessor derecognizes the deposit liability and recognizes a corresponding amount of lease income.

- *Direct financing lease*: The lessee does not effectively obtain control of the asset, but the lessor relinquishes control. This occurs if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee)7 represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor would collect the lease payments and any amounts related to the residual value guarantee(s). The lessor derecognizes the underlying asset and recognizes a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). The lessor's profit and initial direct costs are deferred and amortized into income over the lease term. In addition, the lessor recognizes interest income from the lease receivable over the lease term.

6 The FASB decided not to allow leveraged lease treatment for new leases after the effective date of ASC 842. Existing leverage leases are grandfathered unless modified after adoption.
7 If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair value of the underlying asset, the lessor classifies the lease as a sales-type lease.

- *Operating lease*: All other leases are operating leases. In a manner similar to current US GAAP, the underlying asset remains on the lessor's balance sheet and is depreciated consistently with other owned assets. Income from an operating lease is recognized on a straight-line basis unless another systematic basis is more appropriate. Any initial direct costs (i.e., those that are incremental to the arrangement and would not have been incurred if the lease had not been obtained) are deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

Connecting the Dots

While the FASB's goal was to align lessor accounting with the new revenue guidance in ASC 606, an important distinction may affect P&U lessors, particularly those in the renewable energy sector. Under ASC 606, variable revenues are estimated and included in the transaction price, subject to a constraint. By contrast, under the new leases standard, variable lease payments would generally be excluded from the determination of a lessor's lease receivable. Accordingly, a direct financing lease or a sales-type lease that has a significant variable component may result in a loss at commencement (i.e., a day 1 loss) for the lessor if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). At the FASB's November 30, 2016, meeting, the Board discussed whether a day 1 loss would be appropriate in these situations or whether other possible approaches would be acceptable, including the use of a negative discount rate to avoid the loss at commencement. The Board asserted that while stakeholders may disagree with the day 1 loss outcome, ASC 842 is clear on how the initial measurement guidance should be applied to sales-type and direct financing leases. In addition, the Board stated that the use of a negative discount rate would not be appropriate and should not be applied under ASC 842[8].

For those leases that are classified as sales-type or direct financing leases, there are still open questions on the accounting for non-routine capital projects, such as major maintenance to a plant, that are typically performed and capitalized by the asset owner under a defer and amortize model. Because the lessor will derecognize the underlying asset, there is an open question about whether it would be appropriate to capitalize the major maintenance costs for an asset that is no longer recorded on the balance sheet.

Lessors affected by these issues should consult with their professional advisers and monitor developments during the ASU's implementation phase.

Connecting the Dots

In July 2018, the FASB issued ASU 2018-11, which contained two targeted improvements to ASU 2016-02. The first targeted improvement was to provide an additional transition method, whereby entities initially apply the new lease standard at the adoption date, and recognize a cumulative-effect adjustment to the opening balance sheet of retained earnings in the period of adoption, and not restate comparative periods. See further discussion of this in the Effective Date and Transition section below.

The second targeted improvement was to provide a practical expedient for lessors to elect not to separate lease and nonlease components when both (1) the timing and pattern of transfer of the lease components and nonlease component(s) are the same, and (2) the lease component, if accounted for separately, would be classified as an operating lease. However, if the nonlease component or components associated with the lease component are the predominant component of the combined component, the entity is required to account for the combined component under ASC 606.

This practical expedient could offer relief to lessors in the P&U industry in situations in which contracts provide a lease and related maintenance services (e.g., a contract that contains a lease of a natural gas-fired electric generating facility and the related operations and maintenance services associated with that facility), provided the above conditions are met. Entities that elect the lessor practical expedient should provide disclosures indicating the election of the practical expedient, the classes of underlying assets where the lessor made the election, the nature of the lease and nonlease components that were combined and any nonlease components that were not eligible for the practical expedient, and the framework the entity is applying to the combined component (e.g., ASC 606 or ASC 842).

Effective Date and Transition

The new guidance is effective for PBEs for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning January 1, 2021), and interim periods thereafter. The transition relief amendments in ASU 2018-11 apply to entities that have not yet adopted ASC 842. Entities that early adopted ASC 842 before the issuance of ASU 2018-11 cannot elect the alternative additional transition method described below. Early adoption is permitted for all entities.

8 As specified in Issue 2 of ASU 2018-10, if when applying the definition of the term rate implicit in the lease results in a rate that is less than zero, a rate implicit in the lease of zero should be used.

As mentioned above, an entity may elect to initially apply the new lease standard at the adoption date, and recognize a cumulative-effect adjustment to the opening balance sheet of retained earnings in the period of adoption, and not restate comparative periods. In doing so, the entity would:

- Apply ASC 840 in the comparative periods.
- Provide the disclosures required by ASC 840 for the comparative periods.
- Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the effective date (e.g., January 1, 2019 for a calendar-year PBE).

The entity would not:

- Restate comparative periods (e.g., 2017 and 2018) for the effects of applying ASC 842.
- Provide the disclosures required by ASC 842 for the comparative periods (e.g., 2017 and 2018).
- Change how the transition requirements apply, only when the transition requirements apply.

Connecting the Dots

The FASB received feedback from preparers that were experiencing additional and unexpected costs related to the current transition requirements in ASU 2016-02. Those stakeholders indicated that they lack the IT solutions and systems providers to handle the comparative-period reporting requirements of the modified retrospective transition approach, thereby increasing the cost and complexity to those stakeholders of restating comparative periods under ASC 842.

The Board was sympathetic to this feedback and, accordingly, voted to amend the standard. In doing so, several Board members noted that the tentative decisions effectively delay lessees' recognition of lease assets and lease liabilities by one year (i.e., PBEs need to present only two years of balance sheet information). Those Board members noted that, in this instance, the benefits to preparers of delaying balance sheet recognition by one year exceeded the costs of requiring them to provide comparative balance sheet information. Further, they indicated that given ASC 842's dual approach to lessee accounting, the new standard does not significantly affect the income statement. Therefore, comparability will not be significantly affected if entities do not restate two years of comparative income statement information.

The Board expects that the new transition election will relieve entities from the cost burdens—described above—that are associated with providing comparative information under the modified retrospective transition approach. However, many entities will still need to enhance their lease-related IT systems as a result of the new standard's data requirements. In addition, the new standard's requirements related to judgments and estimations have not changed, and new processes and internal controls will still need to be instituted accordingly. Therefore, we do not think that the Board's decision suggests that entities should slow their implementation efforts.

Implications for P&U Entities

Power Purchase Agreements

As previously mentioned, under current lease accounting guidance, a PPA is accounted for as a lease if the off-taker (1) agrees to buy all, or substantially all, of the output(s) of a specified generating asset and (2) pays for the output(s) at pricing terms that are neither fixed per unit nor equal to the current market price per unit at the time of delivery. However, the new definition of a lease focuses on whether the off-taker has control of the right to use the specified generating asset. That is, an arrangement is not considered a lease solely on the basis of the pricing, and the extent, of outputs purchased under the contract. Rather, entities have to determine whether a PPA gives the off-taker control of an identified generating asset because the off-taker has the right to direct, and obtain substantially all of the economic benefits from, the use of the asset.

Right to Direct the Use of the Asset

An off-taker has the right to direct the use of a specified generating asset if it can determine how and for what purpose that asset is used. Further, the extent to which an off-taker determines how and for what purpose the specified generating asset is used will depend on whether the PPA grants the off-taker decision-making rights over that asset. Therefore, an off-taker should (1) identify the decision-making rights that most affect how and for what purpose the generating asset is used throughout the off-taker's period of use (i.e., which decision-making rights most affect the economic benefits to be derived from the use of the generating asset) and (2) determine who controls those rights. Dispatch rights will generally convey control to the off-taker. Curtailment rights should also be analyzed. If the decisions related to how and for what purpose the asset is used are predetermined (by contract or the nature of the asset), the assessment will focus on whether the off-taker controls the operations and maintenance (O&M) or designed the asset, either of which would be deemed to convey the right to direct the use of the identified asset to the off-taker. We expect that the decisions related to how and for what purpose the asset is used will be predetermined for many arrangements involving renewable energy generation, given the limited number of strategic decisions about generating assets that are made during the commercial operations phase.

Connecting the Dots

As described above, we expect that dispatch rights held by the buyer will constitute control under the new standard. In some markets, however, dispatch decisions are ultimately made by an ISO on the basis of a consideration of bid prices and any transmission system constraints (i.e., assuming no constraints, generating units will be dispatched economically by accepting the lowest bids first), and therefore neither the owner nor the off-taker can mandate physical production. While the bid-in process is not explicitly the same as dispatch rights held by an off-taker, entities should consider whether controlling the bidding process conveys control to the off-taker, since that is the right that an owner would normally exercise in these markets to influence whether and when the owner's plant runs. We do not believe it would be appropriate to conclude that a generating asset in an ISO can't be leased simply because the ISO has the final say on dispatch.

In the renewable energy sector, off-takers typically buy under must-take arrangements and dispatch rights are not present because of the weather-dependent nature of the generating assets. However, it is common for off-takers to have curtailment rights for both operational (e.g., to protect the grid) and economic (e.g., to avoid buying at a loss when locational marginal prices are negative) reasons. While such rights should be analyzed to understand their purpose and financial consequences to the off-taker, we do not expect curtailment rights to convey control in most circumstances. We believe that the important control decisions (those about how and for what purpose) have effectively been predetermined for weather-dependent assets such as wind and solar farms. Curtailment rights protect a purchaser from unforeseen operational and market pricing anomalies but are inherently different from dispatch rights on a unit that is standing ready to produce.

It is important to note that the decision-making rights that most affect the economic benefits to be derived from a generating asset will differ depending on the nature of the asset. The table below discusses decision-making rights that an off-taker may be granted in a PPA and presents our current thinking on whether those rights determine how and for what purpose fossil fuel and alternative generating assets are used.

Nature of generating asset	Off-taker's decision-making rights	Do the off-taker's decision-making rights determine how and for what purpose the generating asset is used?
Fossil fuel (e.g., coal, natural gas)	Dispatch rights (i.e., rights to make decisions about whether, and how much, to produce from the generating asset).	Yes. Dispatch rights provide the off-taker with the right to change whether electricity is produced from the generating asset and the quantity of the electricity that is produced, which are the decision-making rights that most affect the economic benefits to be derived from the generating asset and together represent the right to determine how and for what purpose the asset is used throughout the period of use.
	Rights to provide the fuel used by the generating asset to generate electricity and determine generation timing (i.e., a tolling arrangement).	Yes. The off-taker's right to toll fuel through the generating asset for conversion into electricity inherently provides the off-taker with the right to change when, whether, and how much the electricity is produced from the generating asset. Those decision-making rights most affect the economic benefits to be derived from the generating asset and thus determine how and for what purpose the asset is used throughout the period of use.
	Rights to make decisions about the operation and maintenance of the generating asset throughout the period of use.	No. Although operating and maintaining the generating asset is essential to its efficient use, decisions about those activities do not by themselves most affect how and for what purpose the generating asset is used; rather, they are contingent upon the decisions about how and for what purpose the generating asset is used (e.g., dispatch rights, contractually stated production schedule).
	Rights that require the supplier to follow prudent utility operating practices in running the generating asset.	No. Requirements that either party in an off-take arrangement must follow appropriate utility operating practices define the scope of the parties' rights related to the generating asset but do not affect which party has the right to direct the use of the asset.
Alternative (e.g., wind, solar)	Design of the generating asset before its construction.	Yes. The relevant decisions about how and for what purpose the asset is used are predetermined on the basis of the nature of the asset. However, the off-taker made the decisions about the generating asset's design before contract inception that predetermined how and for what purpose the generating asset will be used throughout the off-taker's period of use.

Nature of generating asset	Off-taker's decision-making rights	Do the off-taker's decision-making rights determine how and for what purpose the generating asset is used?
	Rights to make decisions about the operation and maintenance of the generating asset throughout the period of use.	Yes. The relevant decisions about how and for what purpose the asset is used are predetermined on the basis of the nature of the asset. Accordingly, decisions about operating and maintaining an alternative generating asset are often among the only decisions available to be made throughout the period of use that do affect the economic benefits to be derived. Thus, the off-taker's decision-making rights over O&M—and the lack of any rights held by the supplier to change those instructions—give the off-taker the right to direct the asset's use throughout the period of use.
	Rights that require the supplier to follow prudent utility operating practices in running the generating asset.	No. Requirements that either party in an off-take arrangement must follow appropriate utility operating practices define the scope of the parties' rights related to the generating asset but do not affect which party has the right to direct the use of the asset.

Connecting the Dots

We anticipate that the assessment of an entity's involvement in design will require the use of significant judgment under the new standard and will be particularly relevant for arrangements involving renewable generating assets. Because those assets are not dispatchable, an entity is likely to conclude that how and for what purpose a generating asset is used are predetermined (on the basis of the nature of the asset). Accordingly, the analysis will likely focus on control over O&M or design. Control over O&M will probably be easy to determine; typically, the asset owner (the supplier) retains responsibility for O&M. However, it will often be more difficult to determine whether the off-taker had sufficient involvement in the design of the facility to effectively convey control. Important decisions regarding design are likely to include siting and determining the specific technology to be used. In addition, we understand that the industry is considering whether configuration decisions are a critical element of design.

The discussion above is premised on the notion that many renewable generating assets cannot be dispatched by the customer. This premise may need to be revisited as advances in battery technology provide for temporary storage of renewable energy. We believe that it will also be important for entities to identify the appropriate unit of account when dealing with battery storage solutions (i.e., is the appropriate unit of account for performing the lease analysis the entire installation or just the battery?).

Other important decision-making rights that affect the economic benefits to be derived from a generating asset should also be considered in the assessment of whether the off-taker's decision-making rights most affect how and for what purpose the asset is used. Such rights may include but are not limited to:

- The off-taker's right to determine the facility's operator.
- The off-taker's right to determine specific operating procedures, outside those requiring the operator to follow prudent utility operating practices.

In all scenarios, the off-taker needs to evaluate, on the basis of the specific facts and circumstances, whether it has the right to determine how and for what purpose a generating asset is used and, thus, the right to direct the use of the asset. The off-taker will need to use judgment when performing this evaluation.

Right to Obtain Substantially All of the Benefits From the Use of the Asset

For a PPA to be considered a lease, the off-taker must also have the right to obtain substantially all of the economic benefits from the use of the generating asset throughout the period of use. Although the FASB did not define "economic benefits," the term as used in the new standard encompasses all economic benefits from the use of an asset (whether tangible or intangible), including products, by-products, and other benefits that may be realized through a subsequent transaction with a third party. Therefore, an off-taker will conclude that certain other benefits provided in a PPA (e.g., capacity, renewable energy credits, or steam) constitute economic benefits. An off-taker will have to consider how the receipt or nonreceipt of such additional benefits from the use of a facility affects the accounting for a particular contract. Note that tax attributes related to ownership of the asset are not considered economic benefits (e.g., investment tax credits (ITCs) and production tax credits (PTCs)).

Connecting the Dots

Questions have arisen about whether PTCs should be deemed economic benefits, given that they are tied to the use of the productive asset (as opposed to ITCs, which are tied to installed cost). We believe that all tax attributes should be excluded from the economic benefits test, as they all belong to the owner(s) of the asset and cannot be sold in a market transaction. This approach is consistent with the way outputs are determined today in the identification of leases under ASC 840[9].

Transportation and Storage Contracts

Contracts to transport or store gas or other fuel products will need to be evaluated under the new definition of a lease. To be considered a specified asset under the new leases standard, a capacity portion of a larger asset has to be physically distinct or have substantially all of the larger asset's capacity. Because the terms of pipeline and storage contracts vary significantly (e.g., regarding the rights to a percentage of an asset's capacity or other economic benefits), entities need to evaluate such contracts to determine whether to account for them under the guidance on leases, revenue recognition (suppliers), derivatives, or other US GAAP.

Last-Mile Scenarios

In addition, P&U entities should also be aware that the new standard specifically highlights by way of example that a pipeline lateral that is dedicated to one user is a distinct portion of a larger asset that would be considered an identified asset. On the surface, this seems to capture any arrangements for transportation service that include dedicated stretches of service—most notably those involving infrastructure connecting a single customer (e.g., a commercial or industrial customer) to the natural gas pipeline in a utility's territory. These are commonly called last-mile scenarios in reference to the connection to the customer site using infrastructure that is effectively dedicated. Entities should consider the potential ramifications of this guidance for elements of their distribution systems, including wires, meters, and other equipment that serve a single customer. While the lateral example is highlighted as an identified asset, questions have arisen about "how an entity determines whether the customer has the right to control the use of that pipeline lateral throughout the period of use (that is, whether there is a lease of the pipeline lateral)."[10]

At a public meeting in May 2017, the FASB agreed that under ASC 842-10-15-16, a pipeline lateral is an identified asset and that the assessment of whether it is a lease must be focused on whether the customer has the right to control the use of the identified asset in accordance with ASC 842-10-15-4. While highlighting that the specific facts and circumstances of each arrangement must be considered, the Board agreed with the staff's analysis of two types of pipeline laterals[11] (below) and did not suggest any additional standard setting was required at the time of the meeting:

- Type 1: These "typically are connected to an integrated pipeline system" and are the most common type of pipeline laterals. While they are not capable of operating on their own, they share "supply sources with the main line and other customers." The pipeline owner retains both economic benefits from the asset's use that are more than insignificant and (2) the right to direct the use of the asset over the period of use. Depending on the significance of retained rights, the Board agreed with the staff's analysis that Type 1 pipeline lateral contracts do not contain a lease.
- Type 2: These "are fully capable of operating using their own dedicated assets" and "the customer has the right to substantially all the pipeline lateral's capacity." The Board agreed with the staff's analysis that in this case there is a lease since the customer has "the right to obtain substantially all the economic benefits . . . and the right to direct the use of the pipeline lateral throughout the period of use."

Connecting the Dots

The guidance that supports laterals as being identified assets could have much broader implications for P&U entities. In particular, it raises a question about whether certain P&U electric transmission and distribution assets would represent identified assets. For example, an analogy could be made that power lines connecting one customer to the broader distribution system would represent identified assets under the new standard. Similarly, questions could be raised about whether meters and other equipment maintained at a customer location would be considered identified assets (as indicated above, an assessment of control would also be required, and this aspect is not presupposed by ASC 842). From a practical standpoint, equipment supporting at-will customers will probably not be subject to a lease because of the lack of a term arrangement between the utility and the customer. However, where term arrangements do exist (e.g., with some commercial and industrial customers), this guidance could be relevant.

We believe that the observations made by the FASB in May 2017 regarding control of pipeline laterals are informative when an entity is thinking about electric transmission and distribution (T&D) infrastructure and will generally support a conclusion that such connections do not give rise to leases. The electric wires a P&U entity uses in its T&D infrastructure less commonly function as Type 2 pipeline laterals because (1) they are less likely to have a cutoff point after which the customer has the right to use the

9 As outlined in ASU 2016-02.BC135, benefits derived from ownership of the asset (e.g., income tax credits) are excluded from the evaluation of economic benefits.
10 Quoted material is from the FASB's May 10, 2017, meeting handout.
11 See Footnote 7.

wires and cables independently from the larger system and (2) a cutoff point, if one exists, is most likely to be very close to the customer's facility. While these wires may not function as Type 1 laterals because the supplier typically cannot use the first-mile/last-mile connection to manage its larger network, the important point is that they rarely function alone, without the assistance of the larger system. Accordingly, we think that it will be rare for the customer to have the right to control the use of first-mile/last-mile connections of electric wires. However, this will ultimately depend on the facts and circumstances of each arrangement.

Pole Attachments

Questions have arisen regarding pole attachment arrangements, whereby either a utility attaches its lines to a pole owned by a third party (e.g., a phone company), or a third party (e.g., a cable company) attaches its wires to a pole owned by a utility. Such arrangements have been referred to as secondary-use arrangements, in which a customer shares the use of part of a larger asset for a defined period. In the case of pole attachments, the owner of the pole continues to use the entire asset while allowing another party to use a portion of the asset for a different purpose over a defined period. We understand that shared-use utility pole arrangements often allow the owner of the pole to relocate the attached equipment (e.g., wires or cables) as long as service is not compromised. This may represent a substantive substitution right held by the pole's owner, in which case there will not be an identified asset in the arrangement.

In the absence of any substantive substitution rights held by the pole owner, we are often asked (1) what unit of account to use for the evaluation of control (the larger asset or the portion being shared) and how to assess economic benefits when two parties contemporaneously use the same asset.

In determining what unit of account to use for the evaluation of control (i.e., the entire utility pole or just the portion being shared with a nonowner), entities should consider (1) whether all parts of the pole are functionally identical and are not physically distinct and (2) whether the attachment by the nonowner is a secondary use of the pole.

To the extent that the portion of the asset being used by the customer has a discrete functional use (e.g., a specific hosting location on a cell tower), it could be more likely that the portion being used is physically distinct and would represent an identified asset (similar to a specific floor of a building). On the other hand, and as is generally the case for a portion of a utility pole, if the portion being used is not functionally distinguishable from the larger asset, there may be a reasonable basis for viewing the larger asset as the identified asset in the arrangement.

We also believe that it is useful for an entity to consider whether the attachment by the nonowner is a secondary use of the pole and what the commercial objectives of the asset owner were when it built or purchased the utility pole. Because utility poles are generally built or purchased without the commercial objective of leasing a specific portion or portions of the pole to others, there may be a reasonable basis to view the larger asset (i.e., the entire utility pole) as the identified asset in the arrangement. On the other hand, assets such as cell towers (which possess specific hosting locations designed to be leased to third parties) are generally designed to lease specific portions of the entire asset to others, in which case we believe that the identified asset, or unit of account, in those arrangements is the specific portion of the larger asset being leased.

Once an entity has identified the unit of account (i.e., the identified asset), the next step is to assess economic benefits in the context of that accounting unit. If the identified asset is deemed to be the entire pole, we would expect the entity to conclude that the arrangement does not contain a lease because the pole owner retains substantial benefits from use.

We believe that there is a reasonable basis for an entity to view the entire utility pole as the identified asset. We would also accept a view that the specific pole location is the identified asset or unit of account and that the party using that location is receiving substantially all of the economic benefits from the use of that location on the utility pole.

Easements

Questions have arisen about whether easements would or could be within the scope of the new standard and, if so, whether the benefit to financial statement users of entities' assessing those arrangements in accordance with the new definition of a lease would outweigh the cost to the entities of doing so (both upon transition and on an ongoing basis).

Generally, an easement is a right to access, cross, or otherwise use someone else's land (i.e., PP&E) for a specified purpose. Most easements provide limited rights to the easement holder, such as the right to cross over land or the right to construct and maintain specified equipment on the land. For example, an electric utility will typically obtain a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by third parties. Easements can be perpetual or term-based, be paid in advance or over time, and provide the customer with exclusive or shared use.

Historically, some entities have considered easements to be intangible assets under ASC 350. In fact, ASC 350 contains an illustrative example of easements acquired to support the development of a natural gas pipeline.[12] By contrast, some entities may have considered easements to be leases or executory contracts. When preparing their financial statements, many entities have presented prepaid amounts related to easements in the PP&E section of their balance sheets because easements are closely associated with the PP&E they support. We understand that FERC's reporting requirements may have also influenced the balance sheet geography for entities regulated by that agency.

In January 2018, the FASB issued ASU 2018-01[13] to address various questions about the impact of ASC 842 on existing and new easements. The stated objectives of the amendments in ASU 2018-01 were to:

- Clarify that land easements entered into (or existing land easements modified) on or after the effective date of the new leasing standard must be assessed under ASC 842.
- Provide an optional transition practical expedient for existing or expired land easements that were not previously **accounted fo**r in accordance with ASC 840. The practical expedient would allow entities to elect not to assess whether those land easements are, or contain, leases in accordance with ASC 842 when transitioning to the new leasing standard.

Connecting the Dots

The Board indicated at its November 29, 2017, meeting that it would not provide additional, formal guidance on determining the unit of account with respect to performing the lease assessment for an easement. However, several Board members pointed out that an entity will need to use judgment in determining the unit of account and that diversity in practice could arise in this area. Board members have publicly expressed this view at previous meetings, including a July 2017 roundtable and an August 2017 meeting. Further, it was noted that the need to use judgment is not limited to scenarios involving subsurface rights (e.g., rights to run gas pipelines underground). Board members specifically discussed easements that convey only surface rights, including rights to construct renewable energy assets (e.g., wind or solar), noting that an entity will also be required to employ judgment in considering these arrangements and that there could be more than one approach to determining the unit of account.

On the basis of these views, we believe that, in practice, some will conclude that the unit of account is the entire land area defined by the easement contract (e.g., a larger area) while others will decide that a new unit of account should be established and assessed each time the easement holder occupies a portion of the land (e.g., a smaller area, such as the area taken up by a concrete pad used to serve as the foundation for a windmill or a transmission tower). We believe that either of these approaches is acceptable.

The FASB makes its objective for new land easements very clear that all new land easements must first be assessed under ASC 842 to determine whether the arrangement is, or contains, a lease. If an arrangement is not a lease, other GAAP may be applicable (e.g., ASC 350, ASC 360). However, in paragraph BC11 of ASU 2018-01, the Board explains that it intentionally did not address the appropriate accounting guidance to apply in these situations:

> While there may be diversity about which guidance an entity should apply when a land easement is not a lease, that diversity is outside the scope of the amendments in this Update and, accordingly, the amendments do not modify an entity's accounting for land easements that are not leases.

It is important to note that not all land easements are expected to be (or contain) leases, and the FASB decisions simply require companies to make an assessment under ASC 842 for new or modified easements. To determine whether a new or modified land easement contract is, or contains, a lease in accordance with ASC 842-10-15-2 through 15-27, entities may find it helpful to group the contracts into one of two categories, further discussed below: (1) perpetual easements and (2) term-based easements. This may streamline the process since many easements will have similar or identical provisions and therefore would be expected to result in similar accounting.

Perpetual Easements

ASC 842-10-15-3 states, in part, "A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) **for a period of time** in exchange for consideration" (emphasis added). When a land easement is perpetual, we would not expect the arrangement to meet the definition of a lease given the lack of a stated term. In accordance with ASC 842-10-15-3, rights conveyed in a land easement into perpetuity (i.e., for an unlimited time) are not conveyed "for a period of time."

Arrangements with stated terms are not considered perpetual even if the terms are very long (e.g., 100 years). On the other hand, a use condition contained in a perpetual easement (e.g., when an easement conveys rights to the customer into perpetuity, as long as those rights are used only to run fiber-optic cable) would not affect the conclusion that a land easement is perpetual.

12 ASU 2018-01 amended this guidance to clarify that the easements in the example did not meet the definition of a lease under ASC 842. The effective date and transition requirements under ASU 2018-01 are the same as those under ASU 2016-02. An entity that early adopted ASC 842 should apply the amendments in ASU 2018-01 upon its issuance.
13 See Deloitte's October 3, 2017, Heads Up for a detailed discussion of the ASU.

Term-based Easements

For term-based easements, the analysis will most likely be more extensive and involve a consideration of the right to control the use of the underlying land. That is, in accordance with ASC 842-10-15-4, entities will need to assess whether the customer in the arrangement has the right to (1) obtain substantially all of the economic benefits from using the land throughout the period of use and (2) direct the use of the land throughout the period of use. Accordingly, many easement arrangements may not convey the right to control the use of the land to the customer given that the supplier continues to enjoy economic benefits derived from the use of the land and that the rights to direct the use of the land that are conveyed to the customer are limited (i.e., generally only for a specified purpose).

For example, in an arrangement in which a utility (as the easement holder) is allowed to run electric transmission assets through a farmer's fields (i.e., transmission lines that run over or under the farmer's fields), it will be important to understand whether the farmer can still use the acreage subject to the easement (i.e., the acreage under or over which the lines run). If so, the utility may conclude that it does not have the right to control the use of the land because the farmer retains (1) rights to direct the use of the land (e.g., rights to farm the land), (2) economic benefits associated with the land that are not insignificant (e.g., the crops yielded from farming), or (3) both (1) and (2). On the other hand, there may be easement arrangements that effectively convey the right to control the use of the land to the easement holder through the rights conveyed or through use restrictions imposed on the landowner.

In addition, to appropriately identify the unit of account, an entity sometimes may need to more carefully consider the identified asset in an easement arrangement, as illustrated in the common scenarios below.

Example 1

A customer enters into a land easement arrangement with a farmer for the right to pass a natural gas pipeline under the farmer's land. At issue is whether the identified asset includes the entire plot of land or whether the land should be broken down into surface and subsurface rights, the latter of which the parties would evaluate to determine whether the customer has the right to control the use of the land.

If the identified asset is the entire plot of land, the parties are less likely to conclude that the customer has the right to obtain substantially all the economic benefits from use of the land because the farmer retains the surface rights (e.g., to farm the land). However, if the identified asset is only the subsurface rights, the customer might have the right to obtain substantially all the economic benefits from using the area below the surface of the land. Further, subsurface rights for the same plot of land may also be stacked in such a way that one customer has an easement for the depth of 5 to 10 feet below the surface while another customer has an easement for the depth of 10 to 20 feet below the surface.

Example 2

A customer enters into a land easement arrangement with a farmer for the right to construct and maintain 25 wind turbines on the farmer's 500-acre plot of land. Each wind turbine will be constructed on 25 individual square-acre plots. At issue is whether the identified asset is the entire 500-acre plot of land or whether there are 25 identified assets, each one square acre of land.

As in the previous example, if the identified asset is the entire 500-acre plot of land, the parties are less likely to conclude that the customer has the right to obtain substantially all the economic benefits from use of the land because the farmer retains all of the rights to the economic benefits of the remaining 475 acres. However, if the identified assets are 25 individual square-acre plots of land, the customer may have the right to obtain substantially all the economic benefits from using each square-acre plot

As discussed above, FASB members have consistently described this analysis as an area of judgment, and we believe that either approach to the determination of the unit of account in the examples above would be supportable.

Implementation Considerations

The ASU may present significant implementation challenges for P&U entities during the period of transition and beyond, including the following:

- Evaluating new requirements that will involve the use of significant judgment, including estimations related to recognition of leases on the balance sheet.
- Managing the complexities of data collection, storage, and maintenance for a potentially large population of contracts.
- Implementing or enhancing information technology systems through upgrades of existing systems to perform the necessary calculations and reporting requirements.
- Establishing new and refining existing internal controls and other business processes related to identification and capture of contracts subject to lease accounting.
- Determining whether debt covenants will be affected and, if so, working with lenders to avoid violations.
- Identifying and addressing income tax effects.

Application of Judgment and Estimation

Entities will be required to apply judgment and make estimates under a number of the new (as well as current) lease requirements. Judgment is often required in the assessment of a lease's term, which will affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance since almost all leases will be recognized on the balance sheet.

Upon transition, entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate on the date of transition. Compliance with this requirement may be difficult for P&U entities with a significant number of leases, since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, class of asset, residual value guarantees). In other words, P&U entities will not be permitted to use the same discount rate for all their leases unless the leased assets and related terms are similar.

Data Management

P&U entities may have numerous lease agreements at multiple decentralized locations and may, in many instances, maintain their lease data in spreadsheets or physical documents. Consequently, collecting and abstracting the data needed for reporting requirements may be time-consuming and resource-intensive. Further, even if P&U entities already have such information in an electronic format, it may reside in disparate systems or need to be enhanced to ensure that it complies with ASC 842's accounting and disclosure requirements.

In addition, P&U entities may need to gather information required by the ASU that may not be contained in lease agreements. For example, entities may need to acquire information about the fair value of an asset, (2) the asset's estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. Acquiring this data may be particularly challenging for multinational P&U entities whose lease documentation may be prepared in a foreign language and could also vary as a result of local business practices.

As P&U entities identify and collect the data they need for compliance with the ASU's requirements, they should also consider the challenges of ongoing data maintenance. Data gathering and abstraction efforts may take many months to complete, during which time new leases will be executed, renewed, modified, or terminated. Accordingly, it is recommended management establish an approach to data maintenance and controls during the implementation period and beyond.

Given the relationship between lease maturity disclosures under current guidance and lease liabilities that will be recognized upon adoption of the ASU (which could be subject to modified retrospective transition and affect prior year financial reporting, depending on the entity's election), we believe that in preparing their December 31, 2018 financial statements, P&U entities should strive to ensure that they have identified a complete population of leases.

Information Technology Systems

P&U entities may need to enhance their information technology systems, or alternatively implement a new system, to comply with the ASU's requirements. The extent of such enhancements will likely be based on the size and complexity of a P&U entity's lease portfolio and its existing leasing systems. As with any changes to existing systems, a P&U entity should consider the business ramifications (e.g., the potential effect on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions).

Also, management may need to consider system changes that will enable the entity to estimate, before adoption, the ASU's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that a P&U entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between ASC 842 and IFRS 16 and be equipped to handle the differences between the two standards.

Internal Controls and Business Process Environment

To a significant extent, current systems with lease data are used for operational purposes, and thus some aspects of the related internal controls may be outside the scope of the internal control requirements of the Sarbanes-Oxley Act of 2002. Given the increased relevance of the leasing data to the financial statements under the ASU, P&U entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls. Accordingly, P&U entities will likely need to revise their internal controls related to their processes for capturing, calculating, and accounting for their leases. If additional internal controls and processes are needed, P&U entities may also need to issue organizational communications and establish change management and employee training programs.

In addition, during their implementation of the standard, entities may identify potential enhancements to their current processes to achieve operational efficiencies. For example, P&U entities may seek to automate manually intensive processes or consider organizational changes such as a shared services model.

Debt Covenants

Given the requirement to bring most leases onto the balance sheet, many P&U entities will reflect additional liabilities on their balance sheets after adopting the ASU. Such entities should determine whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations. This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use "frozen GAAP" covenants (i.e., covenants that are based on GAAP at the time the debt was issued). The ASU requires presentation of operating lease liabilities outside traditional debt, which may provide relief for some P&U entities. Regardless, we believe that it will be critical for P&U entities to determine the ASU's potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

Income Taxes

A lease's classification for accounting purposes does not affect its classification for tax purposes. Entities will therefore continue to be required to determine the tax classification of each lease under the applicable tax laws. While the lease classification analysis may be similar for each purpose, the differences between tax rules and accounting principles and guidance often result in book/tax differences.

The ASU's requirement for entities to reevaluate their leases under the new guidance presents an opportunity for them to also reassess the tax treatment of such leases as well as their data collection, analytical and documentation processes.

Because the IRS considers a taxpayer's tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent.

P&U entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

Connecting the Dots

Because the potential tax implications are many and varied, it is essential for a P&U entity's tax department to be involved in the evaluation of the leases standard as well as in discussions related to policy adoption and system modifications.

Progress Toward Adoption

P&U entities should consider developing a robust plan and establishing a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider doing the following:

- Performing a current-state assessment of their lease portfolio, including lease volumes and types, availability of electronic lease data and data gaps, and any potential changes related to accounting, taxes, or processes.
- Establishing a granular project plan and road map to manage the effort across multiple functions, business units, and countries, as necessary.
- Developing an approach to, and the resources to perform, the abstraction of the lease data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the ASU's effect on their key metrics and debt covenants.

Time is truly of the essence. As the effective date has passed for public entities (i.e., first financial reporting date of Q1 2019) and approaches for all other entities (Q1 2021), the most important action a P&U entity can take is to start the efforts related to this accounting change now. It can be a challenge to anticipate the data gaps and overcome the data abstraction hurdle, but with adequate support and sufficient time, it can be achieved. By planning properly, P&U entities can help ensure that their transition to the new leases standard is smooth and successful.

How Deloitte Can Help

Deloitte's Experience

Deloitte professionals both in the US and globally are equipped with the latest tools and technology to help you develop an action plan for implementing the new standard.

Our services include help with accounting interpretations, process revisions, system changes (including development of system business requirements), new system implementations, and tax analysis. Deloitte has also developed a suite of user-friendly, web-based tools to help entities maintain lease data and perform lease calculations under the new standard. These tools can help you automate the process of analyzing and abstracting lease contracts; manage a centralized, secure repository; and identify and address key data deficiencies associated with leases. Specific areas of assistance include but are not limited to:

- *Contract assessment*: Reviewing existing contracts to determine the new standard's effect.
- *Contract abstraction*: Leveraging our lease abstraction center of excellence, we can abstract your lease contract data to our Deloitte LeaseControllerTM platform for use on an ongoing basis or for export to use in your lease system.
- *Accounting Policies and Technical Guidance*: Reviewing and/or assisting in the development of processes and policies to appropriately apply accounting requirements.
- *Process challenges*: Implementing a standardized process for consistent reporting and application throughout an entity.

Attached as appendices below, are two documents which highlight the services we can provide related to implementing the new lease standard to both attest and non-attest clients, along with relevant contact information of Deloitte professionals in our Audit & Assurance, Risk and Financial Advisory, and Tax practices.

Deloitte LeaseController

Designed by accountants, for accountants, to help you achieve compliance with new lease accounting standards

As a result of how ASC 842 and IFRS 16 will fundamentally change the rules that govern accounting for all leases, simple spreadsheets and manual processes likely will no longer be sufficient to maintain lease data and perform lease calculations.

That's why Deloitte built LeaseController, a tool designed to help facilitate a company's adoption and streamline the end-to-end lease accounting process from incorporating functionality related to capturing management judgments and decisions to performing computations and generating reporting related to lessee positions.

About LeaseController

- A web-based solution for storing, analyzing, and reporting on lessee related lease accounting information
- Accounts for leases for lessees under four accounting standards: ASC 842, IFRS 16, ASC 840, and International Accounting Standard 17 (IAS 17)
- Covers real estate leases and other lease types, including equipment and vehicles

New standards, new technology solution

ASC 842 and IFRS 16 will likely present significant accounting changes for P&U entities, particularly those with high lease volume. Here are some examples of challenges a company may encounter and how LeaseController can help you address the challenge.

Illustrative challenges of the new standards	Deloitte's LeaseController
• Need for a broad data repository and a calculation engine to more efficiently produce financial reporting	• Provides a central repository to store lease documentation and a calculation engine that allows for analysis and reporting • Enables computations for lessee positions under four accounting standards: ASC 840, ASC 842, IAS 17, and IFRS 16 • Includes transition and modification calculations
• Increases scrutiny from auditors and regulators and may require entities to reexamine their internal controls and processes	• Was built by Deloitte's specialists with this increased scrutiny in mind • Features a web-based file and data registry as well as workflow management and audit trails • Includes built-in content for validation checks • Enables detailed reporting, designed and built to help address audit checks
• Adds reliance on contract data, which may be scattered across multiple decentralized locations, in different business and operating units	• Web-based functionality makes data accessible from any location, anywhere in the world with a secure Internet connection • Pricing is based on the number of active lease contracts, not the number or location of your users
• Drives a need for management judgment in lease assessment as well as robust supporting documentation	• LeaseController includes functionality to support workflows related to capturing management judgments and decisions • Supports several hundred scenarios

Innovation in action

LeaseController facilitates data gathering and storage, analytical reviews, and reporting under current and future rules:

- **Store**: Store and manage lease agreements in a secure and centralized repository to facilitate transition to the new accounting standards. Lease agreements and data elements are organized so you can quickly retrieve information.
- **Analyze**: Maintain accounting schedules for each lease and perform analysis on extracted data. Configuration features allow for management's analysis of accounting change impacts on financial statements.
- **Report**: Use stock and configurable reports to help meet the needs of your organization. Flexibility provides for fast and robust reporting capabilities.

Please contact us for more information about LeaseController or to schedule a demo.

Contacts

If you have questions about this publication, please contact the following Deloitte industry professionals:

Audit & Assurance

Tim Wilhelmy
Partner
Deloitte & Touche LLP
+1 561 962 7744
twilhelmy@deloitte.com

James Barker
Partner
Deloitte & Touche LLP
+1 203 761 3550
jabarker@deloitte.com

Brent Wilberts
Senior Manager
Deloitte & Touche LLP
+1 515 241 2877
bwilberts@deloitte.com

Adam Nicholson
Senior Manager
Deloitte & Touche LLP
+1 704 887 1661
adnicholson@deloitte.com

Casey Fersch
Senior Manager
Deloitte & Touche LLP
+1 203 563 2326
cfersch@deloitte.com

Taylor Paul
Specialist Leader
Deloitte & Touche LLP
+1 203 423 4543
tapaul@deloitte.com

Risk and Financial Advisory

John Vickers
Managing Director
Deloitte & Touche LLP
+1 713 982 2329
jovickers@deloitte.com

Sean Torr
Managing Director
Deloitte & Touche LLP
+1 615 259 1888
storr@deloitte.com

Tax

Dave Yankee
Partner
Deloitte Tax LLP
+1 312 486 9842
dyankee@deloitte.com

Subscriptions

Don't miss an issue! Register to receive Spotlight and other Deloitte publications by going to www.deloitte.com/us/ subscriptions. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

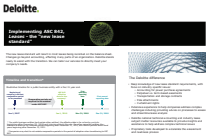
Deloitte Accounting Research Tool and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool (DART), the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

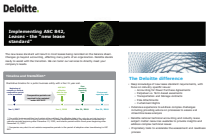
Updated every business day, DART has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive Technically Speaking, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a US GAAP focus. It contains articles on FASB activities and updates to the FASB Accounting Standards Codification™ as well as developments of other US and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

Appendices



Leasing Placemat_PU Attest.pdf



Leasing Placemat_PU Non-Attest.pdf