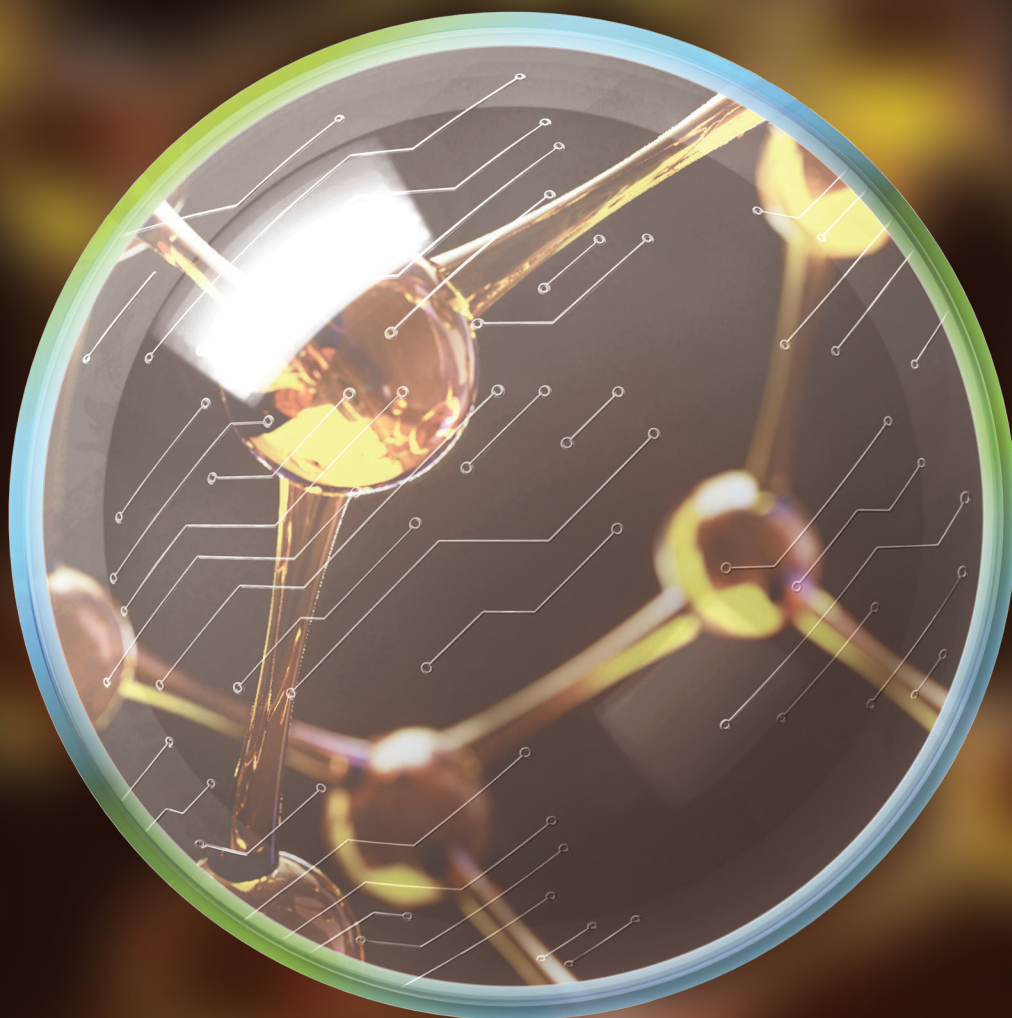


**Deloitte.**



**Life Sciences Industry Accounting Guide**  
Leases

March 2024

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# Preface

The life sciences ecosystem encompasses a wide array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the life sciences industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2024 edition of Deloitte's *Life Sciences Industry Accounting Guide* (the "Guide") addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting and rulemaking developments (through March 8, 2024), and key differences between U.S. GAAP and IFRS<sup>®</sup> Accounting Standards. In addition, this Guide discusses (1) accounting and financial reporting considerations associated with the macroeconomic and geopolitical environment that apply specifically to the life sciences industry, (2) environmental, social, and governance (ESG) matters that have become topics of increased focus, and (3) the impact of the Inflation Reduction Act of 2022 (IRA).

[Appendix B](#) lists the titles of standards and other literature we cited, and [Appendix C](#) defines the abbreviations we used. Key changes made to this Guide since publication of the 2023 edition are summarized in Appendix D.

We hope the Guide is helpful in navigating the various accounting and reporting challenges that life sciences entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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# Chapter 11 — Leases

## 11.1 New Leasing Standard (Codified in ASC 842)

### 11.1.1 Background

In February 2016, the FASB issued [ASU 2016-02](#) (the “new leasing standard,” which, as subsequently amended, is codified in ASC 842). The primary objective of the new standard was to address the off-balance-sheet financing concerns related to lessees’ operating leases. Accordingly, except for those leases that qualify for the short-term lease exemption under ASC 842 (i.e., certain leases with a lease term of 12 months or less), the standard’s lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability in a manner similar to the current approach for capital leases.

The FASB also addressed questions such as:

- Whether an arrangement is a service or a lease.
- What amounts should be initially recorded on the lessee’s balance sheet for the arrangement.
- How to reflect the effects of leases in the statement of comprehensive income.
- How to apply the resulting accounting in a cost-effective manner.

The new leasing standard also aligns certain underlying principles of the new lessor model with those in ASC 606, the FASB’s revenue recognition standard, including those related to the evaluation of how collectibility should be considered and the determination of when profit should be recognized.

### 11.1.2 Scope

The new leasing standard applies to leases, including subleases, of all PP&E. It does not apply to leases of or for the following:

- Intangible assets.
- Exploration for or use of minerals, oil, natural gas, and similar nonregenerative resources.
- Biological assets.
- Inventory.
- Assets under construction.

### 11.1.3 Definition of a Lease

The new leasing standard states that a contract is, or contains, a lease if the contract gives a customer “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 use of [an] identified asset.”
- “The right to direct the use of the identified asset.”

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will reassess whether the contract is, or contains, a lease only in the event of a modification to the terms and conditions of the contract.

The table below summarizes key concepts related to the definition of a lease.

Concept	Requirement	Observation
Use of an identified asset	An asset is typically considered to be an identified asset if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use <b>and</b> would benefit economically from substituting that asset, the asset is not considered “identified,” and there is no lease for accounting purposes (see below).	This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfill the contract.  Distinguishing between a lease and a capacity contract requires significant judgment. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a specific floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless that portion represents substantially all of the asset’s capacity.
Substantive substitution rights	A supplier’s right to substitute an asset is substantive only if both of the following conditions exist: <ul style="list-style-type: none"> <li>• The supplier has the practical ability to substitute alternative assets throughout the period of use.</li> <li>• The supplier would benefit economically from the exercise of its right to substitute the asset.</li> </ul>	The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, the supplier — not the customer — controls the use of the asset.  It is often difficult for a customer to determine whether a supplier’s substitution right is substantive. A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise.



(Table continued)

Concept	Requirement	Observation
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use. The term “substantially all” is generally 90 percent of the economic benefits of the asset.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	<p>A customer has the right to direct the use of an identified asset throughout the period of use if either of the following conditions exists:</p> <ul style="list-style-type: none"> <li>• The customer has the right to direct “how and for what purpose” the asset is used throughout the period of use.</li> <li>• The relevant decisions about how and for what purpose the asset is used are predetermined and (1) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (2) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.</li> </ul>	<p>The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Customers’ rights to direct the use of the identified asset include the rights to change:</p> <ul style="list-style-type: none"> <li>• The type of output produced by the asset.</li> <li>• When the output is produced.</li> <li>• Where the output is produced.</li> <li>• Whether the output is produced and the quantity of that output.</li> </ul> <p>On the other hand, rights that are limited to maintaining or operating the asset may not grant a right to direct how and for what purpose the asset is used.</p>

### 11.1.4 Embedded Leases

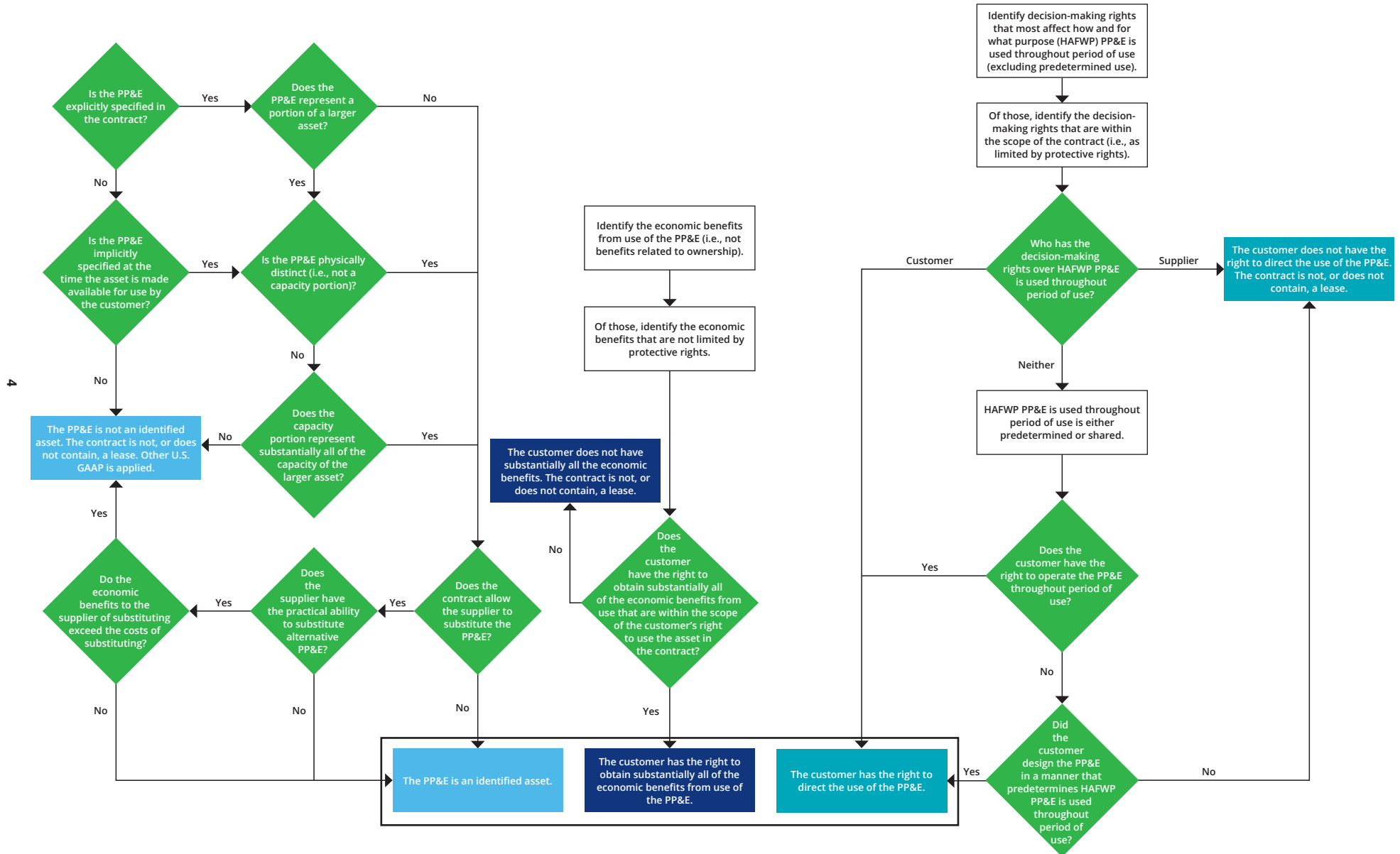
Often, the assessment of whether a contract is, or contains, a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time the asset is made available for the customer’s use.



#### Connecting the Dots

As discussed further in [Chapter 16](#) of Deloitte’s Roadmap *Leases*, entities in transition to ASC 842 may elect a package of transition relief (commonly referred to as “the package of three”) that, among other things, permits entities to retain historical assessments of whether contracts are, or contain, leases. This means that on the effective date of the standard, for those contracts existing as of the date of adoption, the initial ASC 842 accounting is based on those contracts that meet the definition of a lease under ASC 840. Therefore, if entities elect the transition relief package, they should evaluate embedded leases that may not have been identified under legacy U.S. GAAP in accordance with ASC 840. If entities do not elect the transition relief package, they should evaluate whether contracts are, or contain, leases under ASC 842.

The following decision tree illustrates how to evaluate whether an arrangement is, or contains, a lease:



**Example 11-1****Contract Manufacturing Arrangement**

Entity A, a pharmaceutical company, enters into an arrangement with a contract manufacturer, Entity B, to purchase a particular type, quality, and quantity of the API needed to manufacture drug compound X. Entity B has only one factory that can meet the requirements of the contract with A, and B is prohibited from supplying A through another factory or third-party suppliers. Entity A has not contracted for substantially all of B's factory's capacity.

The required quantities of API are established in the contract at inception. Entity B makes all of the decisions about the factory's operations, including when to run the factory to satisfy the required quantities and which customer orders to fulfill.

The contract does not contain a lease. The factory is an identified asset because it is implicit that B can fulfill the contract only through the use of the specific factory. However, A does not have the "right to obtain substantially all of the economic benefits from use of [an] identified asset" since the amount of capacity A has contracted for does not represent substantially all of the factory's capacity. In addition, A does not have the "right to direct the use of the identified asset." While A may specify quantities of product, B has the right to direct the factory's use because it can determine when to run the factory and which customer contracts to fulfill. As a result, A does not meet the new leasing standard's criterion of directing "how and for what purpose" the factory is being used, and the arrangement does not contain a lease.

In accordance with ASC 842-10-15-2, an entity is required at contract inception to identify whether a contract contains a lease. Not all contracts that contain accounting leases will be labeled as such, and accounting leases may be embedded in larger service arrangements.

Failure to identify accounting leases, including those embedded in service arrangements, could lead to a financial statement error. On the other hand, if a customer concludes that a contract is a service arrangement and that contract does not contain an embedded lease, the customer is not required to reflect the contract on its balance sheet (unless required to do so by other U.S. GAAP). The outcome of the accounting assessment of the contract may be more material to the financial statements under ASC 842 than under ASC 840 since the impact of operating leases on the financial statements is often the same as that of service arrangements under ASC 840.

**Connecting the Dots**

Historically, the accounting for operating leases under ASC 840 has generally not been materially different from the accounting for service contracts. However, under ASC 842, since most leases will be recognized on the balance sheet, the financial statement implications of not identifying a lease in a service contract could be more significant than under ASC 840.

For example, under ASC 840, "placed equipment" by a medical device entity may not have represented an identified asset if it was demonstrated that substitution rights existed, which could result in a conclusion that the placed equipment did not represent a lease. Under ASC 842, however, for a medical device entity to conclude that it has a substantive substitution right, it would have to demonstrate not only that it has the practical ability to substitute the placed equipment but also that it would benefit economically from the exercise of its right to substitute the asset. As a result, it is possible that more arrangements that allow for placed equipment will represent an identified asset under ASC 842.

### Example 11-2

#### Placement of Medical Device With Sale of Consumables

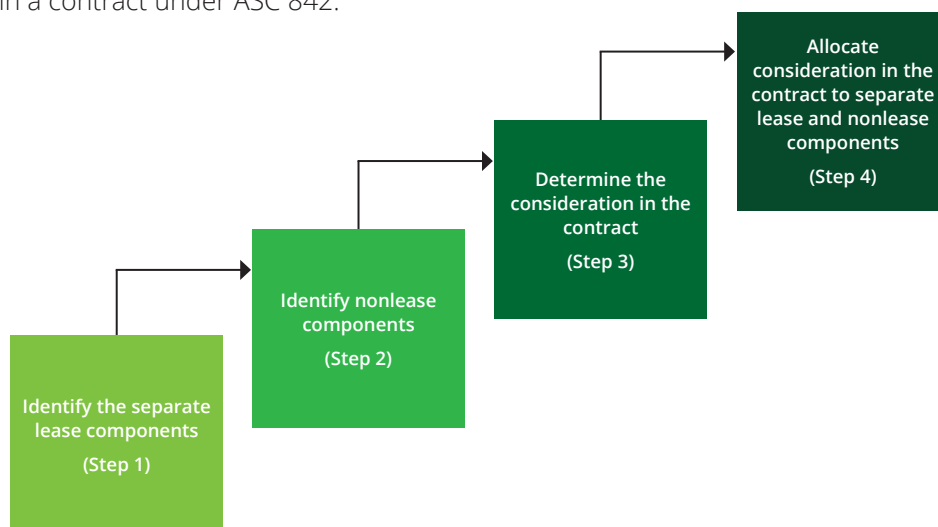
Entity C is a medical device manufacturer that supplies diagnostic kits to customers. The kits can be used only on instruments manufactured by C. Entity C provides its customers with the right to use its instruments at no separate cost to the customer in exchange for a multiyear agreement to purchase annual minimum quantities of diagnostic kits. The term of the agreement generally corresponds to the expected useful life of the instruments. Entity C retains title to the instruments and is permitted to substitute them under the terms of the contract, although historically these instruments have been substituted only when they malfunction since C does not benefit economically from the exercise of its right to substitute the asset.

The multiyear agreement to purchase diagnostic kits contains an embedded lease for the instrument system. The instrument system is an identified asset because it is implicit that C can fulfill the contract only through the customers' use of the specific instruments. Although C has the right to substitute the instruments, the substitution right is not substantive because of the lack of economic benefit from doing so. In addition, customers have the right to control the instruments' use because they have the right to obtain substantially all of the economic benefits from the use of the instruments during the multiyear term of the contract, which corresponds to the useful life of the instruments. Further, customers can make decisions about how and when the instruments are used when the customers perform diagnostic testing procedures.

### 11.1.5 Components of a Contract

A contract can contain both lease and nonlease components. Generally, the nonlease components are services that the supplier is also performing for the customer. For example, in a single contract, the supplier could be leasing a lab facility and related laboratory equipment to a biotechnology customer while also agreeing to provide ongoing maintenance services for the equipment throughout the period of use. Contracts may contain multiple lease components (e.g., leases of land, buildings, and equipment).

The graphic below outlines steps related to considering how to separate, and allocate consideration to, components in a contract under ASC 842.



Identify the  
separate lease  
components  
(Step 1)

Once an entity (a customer or supplier) determines that a contract is, or contains, a lease (i.e., part or all of the contract is a lease), the entity must assess whether the contract contains multiple lease components (i.e., when the contract conveys the rights to use multiple underlying assets). ASC 842-10-15-28(a) and (b) prescribe criteria for identifying whether one lease component is considered separate from other lease components in the contract.

However, land is considered an exception to the guidance in ASC 842-10-15-28. ASC 842-10-15-29 requires an entity to separate a right to use land from the rights to use other underlying assets (e.g., from the right to use a building that sits on top of the land) unless the effect of separating the land is insignificant to the resulting lease accounting.

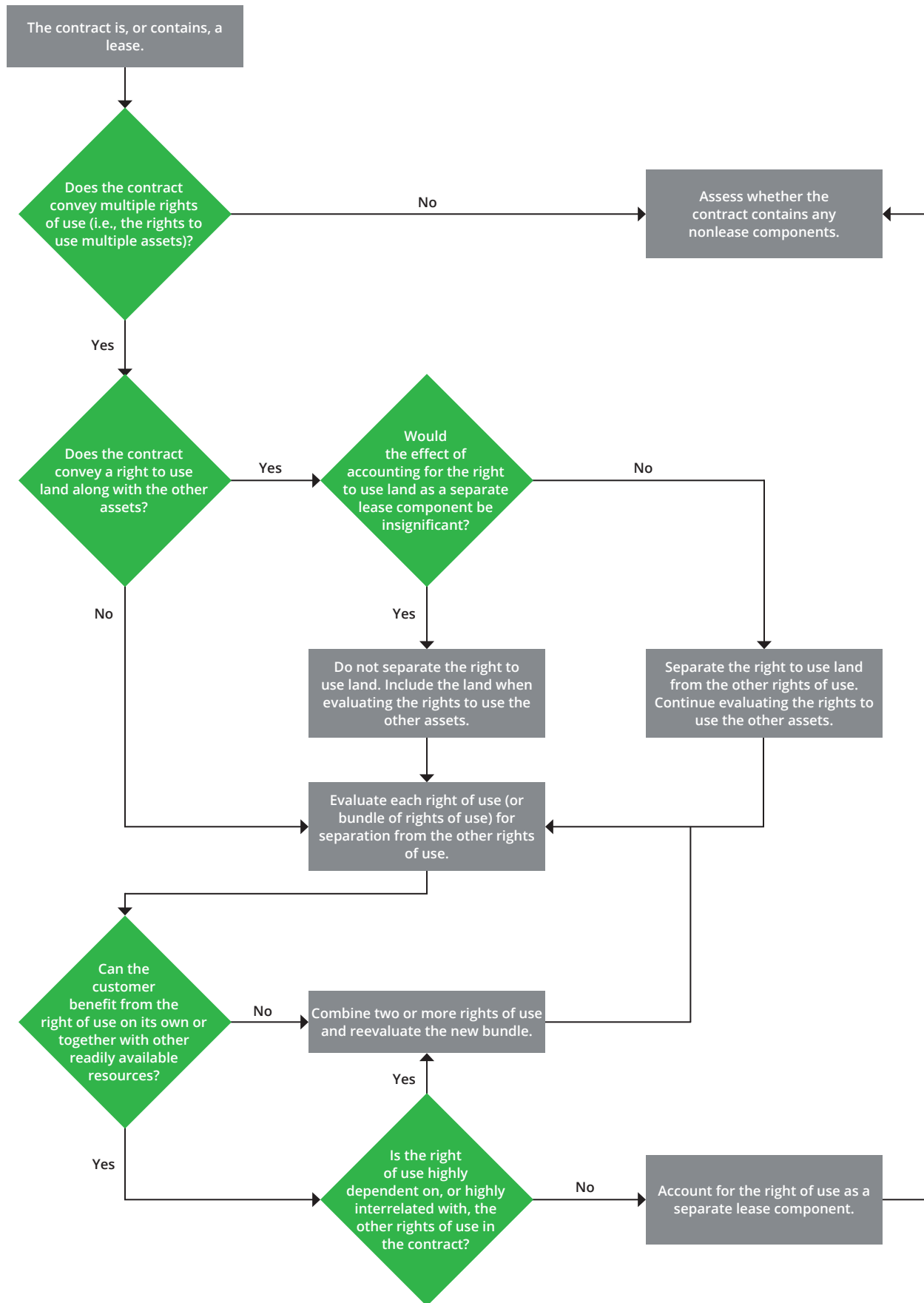


### Connecting the Dots

The new leasing standard indicates that it is important for an entity to identify the appropriate unit of account when applying the lessee or lessor accounting model since the unit of account can affect the allocation of consideration to the components in the contract. Paragraph BC145 of ASU 2016-02 states, in part:

By way of example, regarding allocation, the Board noted that the standalone price (observable or estimated) for a bundled offering (for example, the lease of a data center) may be substantially different from the sum of the standalone prices for separate leases of the items within a bundled offering (for example, the lease of each asset in the data center). Given the substantially different accounting for lease and nonlease components in Topic 842, the allocation of contract consideration carries additional importance as compared with previous GAAP. Consequently, the Board concluded that including separate lease components guidance in Topic 842 will result in more accurate accounting that also is more consistent among entities.




The decision tree on the following page illustrates how an entity might think about the guidance in ASC 842-10-15-28 and 15-29 for each contract containing a lease.



**Identify nonlease components**  
(Step 2)

Once the separate lease components are identified, entities must determine whether there are any nonlease components to be separated. An allocation of contract consideration is required for both lease and nonlease components since they transfer a good or service to the customer. However, allocation of contract consideration does not extend to activities that do not transfer a good or service to the customer, which are referred to as “noncomponents” (e.g., administrative tasks and reimbursement or payment of the lessor’s costs).

Understanding the difference between lease components, nonlease components, and noncomponents is critical. The table below outlines these concepts in greater detail.

<p><b>Lease Component</b></p> 	<p>The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available and (2) the underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement.</p>
<p><b>Nonlease Component</b></p> 	<p>An activity that transfers a separate good or service to the customer is a nonlease component. For example, maintenance services consumed by the customer and bundled with the lease component in the contract would be a separate nonlease component because the performance of the maintenance transfers a service to the customer that is separate from the right to use the asset.</p>
<p><b>Noncomponent</b></p> 	<p>Any activity in a contract that does not transfer a separate good or service to the lessee is neither a lease component nor a nonlease component; therefore, consideration in the contract would not be allocated to such an activity. For example, payments made by the customer for property taxes or insurance that covers the supplier’s interests would not represent a component in the contract.</p>

ASC 842 affords lessees a practical expedient related to separating (and allocating consideration to) lease and nonlease components. That is, lessees may elect to account for the nonlease components in a contract as part of the single lease component to which they are related. The practical expedient is an accounting policy election that must be made by class of underlying asset (e.g., vehicles, IT equipment — see the Connecting the Dots discussion below).

Accordingly, when a lessee elects the practical expedient, any portion of consideration in the contract that would otherwise be allocated to the nonlease components will instead be accounted for as part of the related lease component for classification, recognition, and measurement purposes. In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components).



### Connecting the Dots

ASC 842 provides lessees with two practical expedients that may be elected as an accounting policy by “class of underlying asset”:

- ASC 842-10-15-37 allows lessees not to separate lease and nonlease components.
- ASC 842-20-25-2 allows lessees not to recognize lease liabilities and ROU assets for short-term leases (i.e., leases with a term of 12 months or less).

However, ASC 842 does not address what is meant by the phrase “class of underlying asset.” We have received a number of questions about this topic from various stakeholders, and two views have emerged:

- *View 1* — The class of underlying asset is determined on the basis of the physical nature and characteristics of the asset. For example, real estate, manufacturing equipment, and vehicles would all be reasonable classes of underlying assets given their differences in physical nature. Therefore, irrespective of whether there are different types of similar assets (e.g., within the real estate class, there may be retail stores, warehouses, and distribution centers), the class of underlying asset would be limited to the physical nature as described above.
- *View 2* — The class of underlying asset is determined on the basis of the risks associated with the asset. While an asset’s physical nature may be similar to that of other assets (e.g., retail stores, warehouses, and distribution centers are all real estate, as discussed above), each has a different purpose and use to the lessee and would therefore have a separate risk profile. Consequently, for example, it could be appropriate for the lessee to disaggregate real estate assets into separate asset classes by “type” of real estate — to the extent that the different types are subject to different risks — when applying the practical expedients in ASC 842-10-15-37 and ASC 842-20-25-2.

To support their position, proponents of View 2 refer to paragraph BC341 of ASU 2016-02, which states:

The Board decided that a lessor should treat assets subject to operating leases as a major class of depreciable assets, further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor. **In the Board’s view, leased assets often are subject to different risks than owned assets that are held and used** (for example, the decrease in the value of the underlying asset in a lease could be due to several factors that are not within the control of the lessor), and, therefore, users will benefit from lessors segregating their disclosures related to assets subject to operating leases from disclosures related to other owned property, plant, and equipment. **The Board further considered that to provide useful information to users, the lessor should disaggregate its disclosures in this regard by significant class of underlying asset subject to lease because the risk related to one class of underlying asset (for example, airplanes) may be very different from another (for example, land or buildings).** [Emphasis added]

Irrespective of the views noted above, we do not think that it would be appropriate to determine the “class of underlying asset” on the basis of the lease contract with which it is associated. For example, we believe that it would be inappropriate to break real estate assets into different classes on the basis of whether they are related to gross leases or triple net leases. In that situation, the asset underlying the contract could be the same while the contract terms differ. We do not believe that such an approach is consistent with the intent of the guidance in ASC 842-10-15-37 or ASC 842-20-25-2.

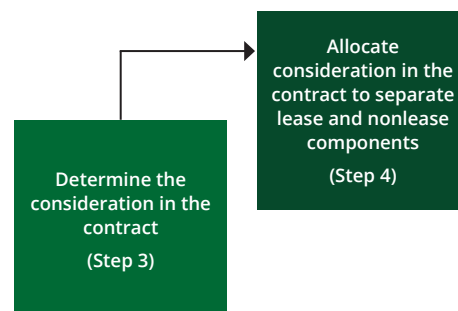
In addition to the practical expedient available to lessees, lessors can elect not to separate lease and nonlease components. This election is made by each class of underlying asset and can only be made if certain criteria are met. Specifically, a lessor can elect to combine a lease component with a nonlease component provided that (1) the timing and pattern of transfer for the lease component are the same as those for the nonlease component associated with that lease component and (2) the lease component would be classified as an operating lease if accounted for separately from the nonlease component. See [ASU 2018-11](#) and [Section 4.3.3.2](#) of Deloitte’s Roadmap [Leases](#) for more information.



At this point, entities have identified their separate lease and nonlease components to which consideration in the contract will be allocated. Noncomponents have also been identified to ensure that consideration in the contract is not allocated to them.

Next, entities must:

- Determine the consideration in the contract.
- Allocate the consideration in the contract to the separate lease and nonlease components.



The matrix below summarizes the requirements related to measuring and allocating the consideration in the contract for lessees and lessors.

	<b>Lessee</b>	<b>Lessor</b>
Determining the consideration in the contract	Includes: <ul style="list-style-type: none"> <li>• Lease payments.</li> <li>• Any other fixed payments.</li> <li>• Any other variable payments based on index or rate.</li> </ul>	Includes: <ul style="list-style-type: none"> <li>• Lessee consideration in the contract (i.e., everything in the column at left).</li> <li>• Estimate of variable consideration (determined under ASC 606) when it is related only to the nonlease component(s).</li> </ul>
Allocating the consideration in the contract to lease and nonlease components	When practical expedient is elected, no allocation is performed.  When practical expedient is not elected, allocate on the basis of: <ul style="list-style-type: none"> <li>• Observable stand-alone price, if readily available.</li> <li>• Otherwise, estimated stand-alone price (maximizing use of observable inputs).</li> </ul>	When practical expedient is elected for eligible nonlease components, no allocation is performed.  When practical expedient is not elected, allocate on the basis of stand-alone selling price in accordance with ASC 606 (see <a href="#">Chapter 7</a> of Deloitte's Roadmap <i>Revenue Recognition</i> ).

### Example 11-3

#### Accounting for an Embedded Lease With Lease and Nonlease Components

Entity A, a pharmaceutical company, enters into an arrangement with Entity B, a CMO, to produce a drug substance by using a dedicated production line designed specifically for the exclusive use of A. Assume that key operating decisions are predetermined by A and that A must approve any changes to production plans.

This arrangement is likely to contain a lease accounted for under ASC 842. The production line is an explicitly identified asset in the contract, there are no substitution rights, and A has the right to obtain substantially all of the economic benefit from the use of the identified asset. In addition, A directs the use of the identified asset because B does not have the right to make operating decisions without A's prior approval.

**Example 11-3 (continued)**

As a result, A should allocate the expected consideration between the leased production line (the lease component) and the services required to produce the drug substance (the nonlease component) on the basis of their relative stand-alone selling prices at the inception of the contract. If the arrangement includes fixed consideration (including minimum monthly volumes at fixed prices), A would record on its balance sheet (1) a lease liability at the present value of the amount of fixed consideration allocated to the lease and (2) a corresponding ROU asset. If the contract contains no minimum volumes, the arrangement would still contain an embedded lease, but the consideration would be 100 percent variable. Because variable consideration is excluded from the measurement of the lease liability, there would be no initial accounting for this agreement. Instead, A would allocate and record a portion of each payment as variable lease expense for the embedded lease component and a portion as the cost of the contract manufacturing. Alternatively, A may elect to use the practical expedient in ASC 842 of not separating the lease component from the nonlease component and accordingly may account for the consideration in the arrangement entirely as lease expense.

In a similar manner, B, the CMO and lessor, may be required to identify two components in this contract: use of the dedicated space (a lease component) and the drug substance output of the contract manufacturing line (a nonlease component).

### **11.1.5.1 Allocating Consideration in Arrangements Involving the Use of an Asset for “Free”**

Vendors in certain industries (e.g., med tech) often provide customers with the right to use, for a specified period, a piece of equipment for no charge (“free equipment”) in exchange for exclusive rights to supply related products (i.e., consumables). The equipment typically can be used only to dispense consumables that are sold by the vendor. In many cases, the customer has the right, but not the obligation, to purchase consumables from the vendor at a specified price. These arrangements may be referred to as “free lease” arrangements because they often contain no explicit consideration related to the use of the equipment; rather, the consideration in the contract consists of a charge per unit of consumable purchased by the customer. Examples of such arrangements may include a contract that conveys the use of an X-ray scanner to a hospital (the hospital may purchase contrast dyes only from the vendor).

When a vendor enters into a free lease arrangement, there must be a determination of whether to allocate the consideration in the contract between the use of the equipment (i.e., a lease component) and the purchase of the consumables (i.e., a nonlease component). In general, we would expect the consideration in the contract (even if the consideration is all variable) to be allocated among the contract components. We would not normally expect a vendor to provide equipment to a customer without expecting compensation. This would suggest that some of the per-unit price of the consumables should be allocated to the use of the equipment.

However, in some limited circumstances, allocating 100 percent of the per-unit price to the consumable sales is permitted if the following criteria are met:

- The contract only includes variable payments not based on an index or rate; that is, the contract does not contain any fixed or in-substance fixed payments.
- The consumables are priced at (or below) their stand-alone selling price.
- The equipment is insignificant in the context of the contract.

If the contract contains a fixed or in-substance fixed payment, as described in ASC 842-10-30-5 and ASC 842-10-15-35 (e.g., a minimum commitment to purchase consumables), such amounts must be allocated between the identified equipment in the arrangement and any nonlease components. In these situations, provided that the customer has the right to control the use of the identified equipment, such a contract contains a lease of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time **in exchange for consideration**” [emphasis added].)

The second criterion is designed to identify scenarios in which a vendor has not “marked up” the consumables to compensate itself for providing the customer with use of the equipment. To the extent that the per-unit price is at or below the vendor’s stand-alone selling price for the consumables (i.e., the per-unit price is the same as or lower than the per-unit price for a customer that purchases the equipment), this fact constitutes evidence that the vendor is not seeking or receiving incremental compensation for the equipment.

If the first two criteria are met, the vendor should evaluate the equipment’s value in relation to the overall combined value of the arrangement (including an estimate of the consumable value by using its best projection of consumables to be purchased over the contract term). The vendor should also consider other relevant factors (qualitative and quantitative) to determine whether the equipment is insignificant in the context of the contract.

The fact that an arrangement satisfies these three criteria may suggest that the vendor has provided the right to use its asset over the term of the contract for no compensation. While future consumable purchases are expected, there are no enforceable rights to require future purchases. Therefore, in a manner consistent with an optional purchase model for a revenue transaction (as described in [TRG Agenda Paper 48](#)), those future consumable purchases are not enforceable and do not create additional consideration in the arrangement, and the customer thus obtains use of the vendor’s asset without any obligation to make payments. This outcome is consistent with a revenue transaction in which a vendor provides its customer with an up-front deliverable (e.g., a razor) for no consideration and expects (but is not able to require) the customer to make subsequent purchases of consumables (razor blades). In this revenue transaction, the vendor would record no revenue for the up-front deliverable (razor) and would incur a day 1 loss upon the transfer of control of the deliverable (razor) to the customer.

#### Example 11-4

Vendor L provides Customer H with “free” diagnostic equipment for a stated noncancelable term of five years. The equipment has no use other than in combination with consumables sold by L to produce a testing result. The equipment is explicitly specified in the contract, and H controls the use of the equipment during the five-year contract term through its exclusive use and ability to direct the use of the equipment. Customer H is required to return the equipment to L at the end of the contract term. The contract contains no explicit consideration for the use of the equipment; the consideration consists of a cost per unit of consumable purchased by H.

Throughout the five-year contract term, H has the right, but not the obligation, to purchase consumables from L to use in operating the equipment. The contract does not contain any minimum purchase commitments related to the consumables. Customer H may only use the consumables with the equipment provided by L and may not use a third-party vendor’s consumables with the equipment.

Vendor L has determined that the stand-alone selling price for the use of the equipment over a five-year term is \$200,000.

**Example 11-4 (continued)****Scenario 1 (Before the Adoption of ASU 2021-05)**

At contract inception, L estimates that H will purchase 100,000 consumables during the five-year contract term. The stand-alone selling price of consumables is \$6 per unit and the selling price within the contract is \$7.50 per unit, yielding an estimated \$750,000 of contract consideration.

On the basis of these additional facts, the contractual price of consumables (i.e., \$7.50 per unit) is higher than the stand-alone selling price of the consumables (i.e., \$6 per unit). The higher contractual price is most likely established to compensate L for the use of the equipment. Even though there are no fixed or in-substance fixed payments, since the price of the consumables is higher than the stand-alone selling price, L would conclude that this contract includes both a lease component and a nonlease component.

Vendor L would be required to allocate consideration between the use of the equipment (a lease) and the sale of consumables. Vendor L will allocate the consideration between the equipment and the estimated future consumable purchases on the basis of their respective stand-alone selling prices, as determined at lease inception. The consideration in the contract is allocated as follows:

Component	Consideration in the Contract	Stand-Alone Selling Price	Allocation Percentage	Allocated Consideration
Five-year lease of equipment (i.e., variable lease income)	\$ —	\$ 200,000	25%	\$ 187,500 (\$1.88 per consumable)
Consumables (i.e., revenue)	<u>750,000</u>	<u>600,000</u>	75%	<u>562,500</u> (\$5.63 per consumable)
Total	<u>\$ 750,000</u>	<u>\$ 800,000</u>	100%	<u>\$ 750,000</u>

Since consideration must be allocated to the use of the equipment, this component of the arrangement will generally meet the definition of a lease (i.e., the right to control the use of identified PP&E for a period of time in exchange for consideration). For each consumable purchased by H, L will recognize \$1.88 as variable lease income and \$5.63 as revenue.

This scenario resulted in a conclusion that a lease exists because the contractual price of consumables is higher than the stand-alone selling price. However, even if this were not the case, because the equipment value is quantitatively assessed as 25 percent of the total contract value, a lease component would most likely still be identified given the significance of the equipment to the overall contract.

Depending on the life of the equipment compared with the contract term (i.e., if the contract term is greater than 75 percent of the useful life of the equipment), these arrangements may qualify as sales-type leases and could lead to commencement losses because of their dependence on variable consideration.

With respect to operating leases of equipment, note that vendors will generally not qualify to use the lessor practical expedient related to not separating the lease (i.e., equipment) and nonlease (i.e., consumables) components in the contract because the transfer of consumables occurs at a point in time whereas the transfer of the leased equipment is over time.

**Scenario 2 (After the Adoption of ASU 2021-05)**

Assume the same facts as Scenario 1. The contractual price of consumables (i.e., \$7.50 per unit) is higher than the stand-alone selling price of the consumables (i.e., \$6 per unit). The higher contractual price is most likely established to compensate L for the use of the equipment. Even though there are no fixed or in-substance fixed payments, since the price of the consumables is higher than the stand-alone selling price, L would conclude that this contract includes both a lease component and a nonlease component.

**Example 11-4 (continued)**

Vendor L would be required to allocate consideration between the use of the equipment (a lease) and the sale of consumables. Vendor L will allocate the consideration between the equipment and the estimated future consumable purchases on the basis of their respective stand-alone selling prices, as determined at lease inception. The consideration in the contract is allocated as follows:

Component	Consideration in the Contract	Stand-Alone Selling Price	Allocation Percentage	Allocated Consideration
Five-year lease of equipment (i.e., variable lease income)	\$ —	\$ 200,000	25%	\$ 187,500 (\$1.88 per consumable)
Consumables (i.e., revenue)	<u>750,000</u>	<u>600,000</u>	75%	<u>562,500</u> (\$5.63 per consumable)
Total	<u>\$ 750,000</u>	<u>\$ 800,000</u>	100%	<u>\$ 750,000</u>

Since consideration must be allocated to the use of the equipment, this component of the arrangement will generally meet the definition of a lease (i.e., the right to control the use of identified PP&E for a period of time in exchange for consideration). For each consumable purchased by H, L will recognize \$1.88 as variable lease income and \$5.63 as revenue.

This scenario resulted in a conclusion that a lease exists because the contractual price of consumables is higher than the stand-alone selling price. However, even if this were not the case, because the equipment value is quantitatively assessed as 25 percent of the total contract value, a lease component would most likely still be identified given the significance of the equipment to the overall contract.

**Before the adoption of ASU 2021-05, the arrangement in the scenario described above may qualify as a sales-type lease depending on the life of the equipment compared with the contract term (i.e., if the contract term is greater than 75 percent of the useful life of the equipment). After the adoption of ASU 2021-05, however, if treating the lease as a sales-type lease would result in the recognition of a selling loss at lease commencement, the lease would be classified as an operating lease in accordance with ASC 842-10-25-3A because of the inclusion of variable consideration.**

(See [Connecting the Dots](#) in [Section 9.3.7.1.2](#) of Deloitte's Roadmap [Leases](#) for more information about commencement losses related to sales-type leases and [Section 11.2.1](#) of this Guide for further discussion of ASU 2021-05.)

**Example 11-5**

Assume the same initial facts as in the example above. At contract inception, Vendor L estimates that Customer H will purchase 450,000 consumables during the five-year contract term. The stand-alone selling price of consumables is \$7.50 per unit, as evidenced by separate observable sales of consumables within contracts in which L sells the equipment to customers. Use of the contractual price of \$7.50 per unit yields an estimated \$3.375 million of contract consideration.

First, L observes that the contract does not include any fixed or in-substance fixed payments throughout the contract term. Then, L considers that its business model is to provide the equipment for free to drive consumable sales, which is corroborated by the fact that the contractual price of consumables is identical to the stand-alone selling price of the consumables (i.e., a customer that purchases the equipment would pay the same price as a customer that signs this contract); L's primary objective is to sell consumables, not to sell the insignificant equipment.

**Example 11-5 (continued)**

The table below illustrates how L may assess the relative value within the contract and how it would allocate the consideration to the potential components.

<b>Component</b>	<b>Stand-Alone Selling Price</b>	<b>Allocation Percentage</b>
Equipment	\$ 200,000	5.6%
Consumables	<u>3,375,000</u>	94.4%
Total	<u>\$ 3,575,000</u>	100%

On the basis of this calculation, L concludes that the equipment value is approximately 5.6 percent of the total contract value. Upon considering this quantitative factor as well as other qualitative factors, L determines that the equipment is insignificant to the overall contract.

Accordingly, in this scenario, it may be acceptable for L to conclude that this contract does not include a lease since L has determined that **no** consideration is provided for the use of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time **in exchange for consideration**” (emphasis added).) As a result, 100 percent of the consideration would be allocated to the sale of the consumables (i.e., revenue). Compared with the conclusion reached in Scenarios 1 and 2 of Example 11-4 above, this conclusion does not result in a timing difference for revenue recognition purposes but could result in a different presentation and disclosure outcome: revenue from contracts with customers and variable lease income would be presented in Scenarios 1 and 2, whereas only revenue from contracts with customers would be presented in this example.

In addition, L should assess whether H obtains control of the equipment (not just the right to use it for five years). If control has been transferred, L would incur a day 1 loss upon delivery of the equipment to H, in a manner similar to the above example involving razors and razor blades.

Conversely, if L determines that H did not obtain control of the equipment, L would continue to recognize the equipment as PP&E subject to the guidance in ASC 360 on subsequent measurement (e.g., depreciation and impairment). Generally, control of the equipment is transferred to the customer when the term of the arrangement constitutes the major part of the remaining useful life of the equipment. However, if the vendor has a right to reclaim the equipment during the term of the arrangement without the customer’s permission (e.g., in cases in which the customer is not purchasing as many consumables as expected), this reclamation right may indicate that control of the equipment has not been transferred.

### 11.1.6 Lease Classification — Lessee

Under ASC 842, at lease commencement, a lease is classified as a finance lease (for a lessee) or a sales-type lease (for a lessor<sup>1</sup>) if any of the following criteria are met:

- “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.”
- “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.”

<sup>1</sup> Refer to [Section 11.2.1](#) for discussion of ASU 2021-05, which creates an exception to these lease classification criteria for lessors.

Finance leases are accounted for in a manner similar to how entities account for a financed purchase arrangement. The lessee recognizes interest expense and amortization of the ROU asset, which result in a greater expense in the early years of the lease than in the later years of the lease. The single lease cost related to an operating lease is recognized on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset. Thus, the amortization of an ROU asset related to an operating lease takes into account the interest on the liability so that the expense amount remains constant. That is, the amortization of the ROU asset will increase or decrease proportionally to the change in interest expense on the liability to maintain a straight-line expense throughout the term of the lease. For both types of leases, the lessee recognizes an ROU asset for its interest in the underlying asset and a corresponding lease liability.



### Connecting the Dots

While many aspects of the lease classification criteria under ASC 842 are consistent with legacy lease accounting guidance, bright-line tests (i.e., whether the lease term is for 75 percent or more of the remaining economic life of the asset or whether the present value of the lease payments, including any guaranteed residual value, is at least 90 percent of the fair value of the underlying asset) are noticeably absent. However, ASC 842-10-55-2 states that these tests are “one reasonable approach to assessing the criteria.” On the basis of this implementation guidance, entities often can use bright-line thresholds as policy elections when evaluating the classification of a lease arrangement under the new leasing standard. However, as with all policy elections, it is important for entities to consider the full range of impact and the need for policy elections to be consistently applied.

## 11.1.7 Lessor Accounting

After proposing different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the lessor model. The most significant changes (1) align the profit recognition requirements under the lessor model with the revenue standard and (2) amend the lease classification criteria for a lessor to make them consistent with those for a lessee. Accordingly, the new leasing standard requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type, direct financing, or operating lease.

Regarding leveraged leases (i.e., leases that met the criteria in ASC 840-10-25-43(c)), paragraph BC397 of ASU 2016-02 explains that the FASB decided to grandfather in existing leveraged leases given that “there would be significant complexities relating to unwinding existing leveraged leases” during transition. Therefore, a lessor must continue to apply the accounting in ASC 840 for such a lease (as carried forward in ASC 842) and classify the lease as a leveraged lease provided that it enters into the lease before the effective date of ASC 842. Otherwise, leveraged lease accounting is eliminated as of the date of adoption.

While the FASB’s goal was to align lessor accounting with the revenue guidance in ASC 606, an important distinction between the two may affect lessors in the life sciences industry. Under ASC 606, variable payments are estimated and included in the transaction price subject to a constraint. By contrast, under ASC 842, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor’s lease receivable. Accordingly, under the guidance in ASC 842 as originally issued, sales-type or direct financing leases that have significant variable lease payments may result in recognition of a loss at commencement because the measurement of the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset.

For example, it is not uncommon for a hospital to contract with a medical device owner for the use of specific medical equipment for a major part of the economic life of the equipment. This type of arrangement is often priced in such a way that the consideration is based entirely on the hospital's ongoing purchase of "consumables," which allow the equipment to function as designed, and may have no minimum volume requirement. The medical device owner is willing to accept variable consideration in the arrangement because demand for the associated health care services suggests that a sufficient volume of consumables will be purchased by the hospital over the term of the contract to make the arrangement profitable. See [Section 11.1.5.1](#) for more accounting considerations related to this type of arrangement.

In July 2021, the FASB issued [ASU 2021-05](#), which requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease on the commencement date of the lease if specified criteria are met. The Board issued the ASU in response to stakeholder feedback indicating that the accounting for such a lease was not faithfully representing the underlying economics of the transaction at lease commencement or over the lease term. When a lease is classified as operating, the lessor does not recognize a net investment in the lease and does not derecognize the underlying asset; therefore, the lessor does not recognize selling profit or loss. See [Section 11.2.1](#) for more information.

### 11.1.8 Real Estate Rationalization

The COVID-19 pandemic ignited a shift in how entities in almost every industry sector are doing business. Many entities are reevaluating where their employees conduct their required business activities and to what extent they will rely on the use of brick-and-mortar real estate assets on a go-forward basis. Specifically, many entities initiated a real estate rationalization program to reevaluate their organization-wide real estate footprint. The goal of initiating such programs may be for entities to rightsize their real estate portfolios to manage costs while adequately supporting their evolving business needs.

We have also observed an increase in entities abandoning properties, subleasing space they are no longer using, or modifying existing leases to change the amount of space or the lease term. Further, as a financing method to improve their liquidity, entities are increasingly entering into sale-and-leaseback transactions involving real estate. As a result of these real estate rationalization efforts, entities are also more frequently evaluating leases for impairment. For more information about these topics, see Sections 11.1.9 through 11.1.12 below and Deloitte's March 30, 2021, [Accounting Spotlight](#).

### 11.1.9 Lease Modifications

A lease modification is any change to the contractual terms and conditions of a lease. Under the new leasing standard, a lease modification is accounted for as follows:

- A lessee or lessor accounts for a lease modification as a separate contract (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.
- A lessee accounts for a lease modification that is not a separate contract by using the discount rate as of the modification's effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.
- A lessor accounts for a lease modification in a manner that is generally consistent with the contract modification guidance in ASC 606.



**Example 11-6****Lease Modifications****Scenario 1 — Modification Resulting in a Separate Contract**

Company A, a pharmaceutical entity (the lessee), enters into an arrangement to lease 15,000 square feet of office space in a complex for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the market rate for the additional 5,000 square feet of space in the complex. Company A would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides A with a new ROU asset at a price that reflects that asset's stand-alone price. While A would be required to disclose certain information about the lease modification, it would not be required to separately record any amounts in its statement of financial position until the separate lease's commencement date (i.e., 18 months from entering into the modification).

**Scenario 2 — Modification Not Resulting in a Separate Contract**

Company A, a pharmaceutical entity (the lessee), enters into an arrangement to lease 15,000 square feet of office space in a complex for 20 years. At the end of year 10, A and the lessor agree to amend the original lease by reducing the annual rental payments from \$60,000 to \$50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), A would remeasure its lease liability to reflect (1) a 10-year lease term, (2) annual lease payments of \$50,000, and (3) A's incremental borrowing rate (or the rate the lessor charges the lessee if such rate is readily determinable) as of the modification's effective date. Company A would recognize the difference between the new and old lease liabilities as an adjustment to the ROU asset. Since the modification does not result in a full or partial termination of the lease, there is no gain or loss on the modification.

**Connecting the Dots**

In response to the COVID-19 pandemic, the FASB provided both lessees and lessors with relief related to accounting for rent concessions resulting from COVID-19. An entity that elects to apply the relief to qualifying concessions may choose to account for the concessions by either (1) applying the modification framework for these concessions in accordance with ASC 840 or ASC 842 as applicable or (2) accounting for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework.

**11.1.10 Subleases**

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. As the intermediate lessor of a leased asset, the entity would determine the classification of the sublease independently from its determination of the classification of the original lease (i.e., the head lease). Under the new leasing standard, the intermediate lessor would classify the sublease on the basis of the underlying asset (i.e., it would assess the term of the sublease relative to the remaining economic life of the underlying asset). When evaluating lease classification and measuring the net investment in a sublease classified as a sales-type or direct financing lease, the original lessee (as a sublessor) should use the rate implicit in the lease if it is determinable. If the implicit rate is not determinable, the original lessee would use the discount rate that it used to determine the classification of the original lease.

In addition, offsetting is generally prohibited on the balance sheet unless the arrangement meets the offsetting requirements of ASC 210-20. However, it may be appropriate in certain instances to net sublease activity in the income statement. See [Section 14.3.1.2.1](#) of Deloitte's Roadmap *Leases* for additional considerations related to when net presentation in the income statement may be appropriate.

**Example 11-7****Accounting for a Sublease Under ASC 842**

As a lessee, Company A, a life sciences entity, enters into a building lease with a 30-year term. The building has an estimated economic life of 40 years. At the end of year 5, A enters into an agreement with Company B, a generics and consumer health entity, under which A subleases the building to B for 20 years. There is no residual value guarantee, and A determines that the present value of the sublease payments received from B does not represent substantially all of the fair value of the building.

As the lessor in its agreement with B, A would account for the lease to B (the sublease) as an operating lease because (1) the term of the sublease is not for a major part of the remaining life of the underlying asset of the sublease (i.e., the sublease term of 20 years represents only 57 percent of the remaining 35-year life of the building) and (2) A has concluded that no other classification criteria would result in the transfer of control of the underlying asset.

**11.1.11 Sale-and-Leaseback Transactions**

The seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) under the requirements of ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the customer). The existence of a leaseback by itself would not preclude the transaction from qualifying as a sale (i.e., it would not indicate that control has not been transferred) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless both of the following criteria are met:

- The option is priced at the fair value of the asset on the date of exercise.
- There are alternative assets that are substantially the same as the transferred asset and readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

If the transaction qualifies as a sale, the leaseback is accounted for in the same manner as all other leases (i.e., the seller-lessee and buyer-lessor would account for the leaseback under the guidance in ASC 842).

Transactions in which a lessee controls an underlying asset before the commencement date of the lease are within the scope of the sale-and-leaseback guidance in ASC 842-40. These transactions include transactions in which the lessee is involved with an asset before that asset is transferred to the lessor and transactions in which the lessee is involved with the construction of the asset (e.g., build-to-suit arrangements). For further discussion of these transactions, see [Chapter 11](#) of Deloitte's Roadmap *Leases*.

Sale-and-leaseback transactions involving real estate that include a repurchase option will not meet the criteria of a sale under ASC 606 regardless of whether the repurchase option is priced at fair value. During the FASB's redeliberation on ASU 2016-02, the Board noted that sale-and-leaseback transactions involving real estate that include a repurchase option would not meet the second criterion in ASC 842-40-25-3. Paragraph BC352(c) of ASU 2016-02 states, in part:

When the Board discussed [ASC 842-40-25-3], Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, "unique" (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is "substantially the same."

Therefore, regardless of whether the repurchase option is priced at fair value, the unique nature of real estate would prevent a sale-and-leaseback transaction involving real estate that includes a repurchase option from satisfying the second criterion in ASC 842-40-25-3 since there would be no alternative asset that is substantially the same as the one being leased. Accordingly, in a manner similar to legacy U.S. GAAP, the new leasing standard would preclude sale-and-leaseback accounting for transactions involving any repurchase options on real estate.

### 11.1.12 Impairment and Abandonment

The ROU assets recorded on a lessee's balance sheet under ASC 842 are subject to the ASC 360-10 impairment guidance applicable to long-lived assets. When events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable (i.e., impairment indicators exist), the asset group should be tested to determine whether an impairment exists. The decision to change the use of a property subject to a lease could be an impairment indicator. See [Section 8.4.4](#) of Deloitte's Roadmap *Leases* for more information about the two-step impairment test.

Although the existence of an impairment indicator would not itself be a reason for a lessee to reevaluate the lease term for accounting purposes, an entity should consider whether any of the reassessment events in ASC 842-10-35-1 have occurred simultaneously with the impairment indicator. See [Example 5-10](#) in [Section 5.4.1.2](#) of Deloitte's Roadmap *Leases* for further discussion of the relationship between these concepts.

The guidance in ASC 360-10 on accounting for abandoned long-lived assets also applies to ROU assets. In the context of a real estate lease, when a lessee decides that it will no longer need a property to support its business requirements but still has a contractual obligation under the underlying lease, the lessee needs to evaluate whether the ROU asset has been or will be abandoned. Abandonment accounting only applies when the underlying property subject to a lease is no longer used for **any** business purposes, including storage. If the lessee intends to use the space at a future time or retains the **intent** and **ability** to sublease the property, abandonment accounting would be inappropriate.

### 11.1.13 Effective Date and Transition

For public companies,<sup>2</sup> the new leasing standard is effective for fiscal years beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein.

<sup>2</sup> That is, (1) PBEs; (2) NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market; and (3) employee benefit plans that file or furnish financial statements with or to the SEC.

For all other entities, the amendments in ASU 2016-02 were originally effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods beginning after December 15, 2020. However, in November 2019, the FASB issued [ASU 2019-10](#), which (1) provided a framework for staggering the effective dates of future major accounting standards and (2) amended the effective dates of certain major new accounting standards to give implementation relief to certain types of entities. In June 2020, the FASB issued [ASU 2020-05](#), which further amended the effective dates to give implementation relief to certain types of entities in response to the COVID-19 pandemic. ASU 2020-05 amended the effective dates of ASU 2016-02 as follows:

	Public Companies <sup>3</sup>	Public NFPs <sup>4</sup>	All Other Entities
As originally issued (ASU 2016-02)	Fiscal years beginning after December 15, 2018, and interim periods therein	Fiscal years beginning after December 15, 2018, and interim periods therein	Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020
As amended by ASU 2019-10	No changes	No changes	Fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021
As amended by ASU 2020-05	No changes	Fiscal years beginning after December 15, 2019, and interim periods therein	Fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022

Entities are required to use a modified retrospective transition method of adoption. The FASB also issued [ASU 2018-11](#) so that entities may elect not to recast their comparative periods in transition (the “Comparatives Under 840 Option”). For more information, see [Section 16.1](#) of Deloitte’s Roadmap [Leases](#).

### 11.1.13.1 Additional Implementation Considerations

Discussed below are some of the additional implementation considerations that life sciences entities should thoughtfully address while transitioning to ASC 842. For further discussion, see Deloitte’s [March 28, 2023](#); [July 1, 2019](#); [October 17, 2018](#); [August 7, 2018](#); [April 25, 2017](#); and [July 12, 2016 \(originally issued March 1, 2016\)](#), *Heads Up* newsletters.

#### 11.1.13.1.1 Operational Considerations

For the lessee accounting requirements to be implemented, information about all individual contracts and arrangements will need to be collected, maintained, and evaluated, including information related to real estate contracts and equipment contracts (e.g., manufacturing equipment, laboratory equipment). In addition, it may be necessary to obtain information outside of contractual arrangements, including (1) 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. The ability to acquire such data may be particularly challenging when contract documentation is prepared in a foreign language and could vary as a result of local business practices.

<sup>3</sup> See [footnote 2](#).

<sup>4</sup> The deferral in ASU 2020-05 applies to public NFPs that have not issued financial statements or made financial statements available for issuance as of June 3, 2020. Public NFPs that have issued financial statements or have made financial statements available for issuance before that date must comply with the effective dates prescribed for public companies above.

### 11.1.13.1.1 *Materiality Threshold*

When implementing the lessee accounting requirements, life sciences companies are likely to consider a materiality threshold, especially for high-volume, low-value leased assets (e.g., laptops). As discussed further in [Section 2.2.5.2](#) of Deloitte’s Roadmap *Leases*, ASC 842 does not contain a “small-ticket item” exception similar to that in IFRS 16. Although materiality is generally a consideration in the application of all accounting standards, life sciences entities should not simply default to their existing capitalization threshold for PP&E for the following reasons:

- The pre-ASC 842 capitalization threshold for PP&E is unlikely to include the effect of the additional asset base introduced by ASU 2016-02. That is, the addition of another set of assets not recognized on an entity’s balance sheet may require a refreshed analysis of the entity’s capitalization thresholds to ensure that the aggregated amounts will not become material.
- The pre-ASC 842 capitalization threshold for PP&E does not take into account the liability side of the balance sheet. Under ASC 842, if an entity wishes to establish a threshold that will be used to avoid accounting for both ROU assets and lease liabilities on the balance sheet, it must consider the materiality, in the aggregate, of all of its ROU assets and related lease liabilities that would be excluded when it adopts such a threshold.

One reasonable approach to developing a capitalization threshold for leases is to use the **lesser** of the following:

- A capitalization threshold for PP&E, including ROU assets (i.e., the threshold takes into account the effect of leased assets determined in accordance with ASU 2016-02).
- A recognition threshold for liabilities that takes into account the effect of lease liabilities determined in accordance with the ASU.

Another reasonable approach to developing a capitalization threshold for leases is to record all lease liabilities but to subject the related ROU assets to such a threshold. Under this approach, if an ROU asset is below the established capitalization threshold, it would immediately be recognized as an expense. In subsequent periods, entities would amortize the lease liability by using the effective interest method, under which a portion of the periodic lease payments would reduce the liability and the remainder would be recognized as interest expense.

### 11.1.13.1.2 *Variable Expense*

Life sciences entities will most likely have contracts with variable lease payments (e.g., real estate contracts with index-based escalators or equipment rental payments based on usage). Entities may find it necessary to create a new general ledger account to track variable lease costs for disclosure purposes in accordance with ASC 842-20-50-4 and to consider impacts of variable lease payments on the accounts payable process.

### 11.1.13.1.2 *Application of Judgment and Estimation*

Entities must use judgment and make estimates under a number of the new as well as legacy lease accounting requirements. Judgment is often required in the assessment of a lease’s term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, since almost all leases will be recognized on the balance sheet, judgment in distinguishing between leases and services becomes more critical under the new guidance.

### 11.1.13.1.2.1 Discount Rates

Entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate at transition and on an ongoing basis. Compliance with this requirement may be difficult for 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, asset type, residual value guarantees). That is, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar.

Additional considerations include:

- *Secured versus unsecured rate* — The definition of the incremental borrowing rate under ASC 842 requires lessees to obtain a collateralized or secured borrowing rate. Unsecured rates are likely to be higher and, therefore, to result in a lower lease liability. If a lessee does not borrow on a secured basis, it will most likely need to make adjustments to its unsecured borrowing rates to reflect a rate of a secured borrowing.
- *Parent versus subsidiary rate* — Sometimes it may be appropriate for a subsidiary to use an incremental borrowing rate other than its own. This will depend on the nature of the lease negotiations and the resulting terms and conditions (e.g., a consolidated group with a centralized treasury function that negotiates on behalf of all of its subsidiaries to benefit from its superior credit).
- *Leases denominated in a foreign currency* — When determining an incremental borrowing rate for a lease denominated in a foreign currency, entities should use assumptions that are consistent with a rate that the entities would obtain to borrow in the same currency in which the lease is denominated. The incremental borrowing rate should still reflect a collateralized rate in the relevant foreign environment.
- *Discount rate in transition* — Entities should determine the discount rate as of the effective date of ASC 842 when initially measuring lease liabilities (under the assumption that the entities continue to account for comparative periods under ASC 840). When selecting a discount rate, entities should elect, as an accounting policy consistently applied to all contracts, to use an interest rate that corresponds to either (1) the original lease term or (2) the remaining lease term.
- *Developing a method* — Life sciences entities should define a method for calculating the incremental borrowing rate that is auditable and supportable at transition and on an ongoing basis.

### 11.1.13.1.3 IT Systems

As a result of implementing the requirements of the new leasing standard, life sciences entities will most likely need to enhance their existing IT systems. The extent of the enhancements will be based on the size and complexity of an entity's lease portfolio and its existing leasing systems. As with any change to existing systems, an entity will need to consider the business ramifications (i.e., the potential impact 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 of ASC 842, the new leasing standard's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that an entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between ASC 842 and IFRS 16 and will need to be equipped to handle the differences between the two standards.

#### 11.1.13.1.4 Income Taxes

A lease's classification for accounting purposes does not affect its classification for tax purposes. A life sciences entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements the new leasing standard, it will need to establish a process to account for these differences. The requirement that entities reevaluate their leases under the new guidance also presents an opportunity for entities to reassess the tax treatment of such leases as well as their data collection and processes. Since 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. 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.

#### 11.1.13.1.5 Covenant Considerations

Given the requirement to bring most leases onto the balance sheet, many companies, including those in the life sciences industry, will reflect additional liabilities on their balance sheets after adopting the new leasing standard. An entity's determination of whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations is a critical aspect of its planning for the new standard's implementation. This determination 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 based on the GAAP that applied at the time the debt was issued). ASC 842 requires presentation of operating lease liabilities outside traditional debt, which may provide relief. Regardless, we believe that it will be critical for all life sciences entities to determine the potential effects of the new leasing standard on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting ASC 842.

## 11.2 Amendments to the New Leasing Standard

The FASB has been working with stakeholders throughout the implementation of ASC 842 to clarify the guidance in the new leasing standard and identify aspects of that guidance that could pose challenges for entities. In response to stakeholders' comments and in a manner consistent with its ongoing Codification improvements project, the Board has issued additional ASUs to clarify the guidance in ASC 842, correct unintended application of the standard, or provide certain relief to entities. To make stakeholders more aware of its amendments to ASC 842, the Board decided to incorporate those amendments into ASUs developed outside of its project on Codification improvements in general.

ASUs issued to date that amend certain aspects of ASC 842 are broadly applicable to the life sciences industry and include the following:

- [ASU 2018-10 on improvements to ASC 842](#) — In July 2018, the FASB issued ASU 2018-10, which makes 16 narrow-scope amendments (i.e., minor changes and clarifications) to certain aspects of ASC 842.
- [ASU 2018-11 on targeted improvements to ASC 842](#) — In July 2018, the FASB issued ASU 2018-11 to provide entities with relief from the costs of implementing certain aspects of the new leasing standard. Specifically, under the amendments in ASU 2018-11:
  - Entities may elect not to recast the comparative periods presented when transitioning to ASC 842.
  - Lessors may elect not to separate lease and nonlease components when certain conditions are met.

For further discussion of ASU 2018-10 and ASU 2018-11, see Deloitte's August 7, 2018, [Heads Up](#).

- [ASU 2019-01 on Codification improvements to ASC 842](#) — In March 2019, the FASB issued ASU 2019-01 to amend certain guidance in ASC 842 in response to feedback from stakeholders. The ASU includes:
  - Guidance on determining the fair value of the underlying asset for lessors other than manufacturers or dealers that aligns with certain legacy guidance in ASC 840.
  - A clarifying amendment that exempts lessees and lessors from providing certain interim disclosures in the fiscal year in which they adopt the new leasing standard.
- [ASU 2019-10 on effective dates of ASC 842 \(and those of other Codification topics\)](#) — In November 2019, the FASB issued ASU 2019-10 to change, among other effective dates, those of ASC 842 for non-PBEs to fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.<sup>5</sup> At the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object if specified PBEs adopt ASC 842 by using ASU 2019-10's timelines that apply to non-PBEs (the "SEC staff position").
- [ASU 2020-02 on an amendment to the SEC paragraph in ASC 842 \(and the addition of an SEC paragraph in ASC 326\)](#) — In February 2020, the FASB issued ASU 2020-02 to codify, among other SEC staff guidance, the SEC staff position permitting specified PBEs to use the non-PBE effective dates of ASC 842 provided for in ASU 2019-10. ASU 2020-02 codifies the SEC staff position by adding a note to ASC 842-10-S65-1.
- [ASU 2021-05 on lessor's accounting for certain leases with variable lease payments](#), [ASU 2021-09 on the discount rate for lessees that are not PBEs](#), and [ASU 2023-01 on common-control arrangements](#) — These ASUs are discussed in greater detail below.

For a complete list of ASUs issued to amend and clarify the guidance in ASC 842, see [Section 17.3.1](#) of Deloitte's Roadmap [Leases](#).

<sup>5</sup> In June 2020, the FASB issued [ASU 2020-05](#), which further amends the effective dates of ASC 842. See [Section 11.1.13](#) for more information.



## 11.2.1 ASU 2021-05 on Lessor's Accounting for Certain Leases With Variable Lease Payments

### 11.2.1.1 Background

In July 2021, the FASB issued [ASU 2021-05](#), which requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate (hereafter referred to as “variable payments”) as an operating lease on the commencement date if specified criteria are met.

Before the release of the ASU, sales-type leases or direct financing leases with significant variable payments may have resulted in a day 1 loss on the arrangement even if the overall economics of the arrangement were expected to be profitable. This is because, under ASC 842, variable payments are excluded from the definition of lease payments for both lessees and lessors. Accordingly, lessors exclude variable payments when measuring the net investment in the lease. As a result, the amount recognized for the net investment in the lease may be less than that derecognized for the underlying asset. The example below illustrates this concept.

#### Example 11-8

Assume that a hospital (as lessee) enters into a 20-year contract with a medical device owner (as lessor) for the use of specific medical equipment for a major part of the economic life of the equipment. All payments are variable since they are based entirely on the hospital's ongoing purchase of consumables, which allow the equipment to function as designed, and there is no minimum volume requirement. The carrying value of the medical equipment is \$10 million just before the commencement of the arrangement, and the present value of the expected residual asset value is \$500,000. Because the hospital is involved in the ongoing purchase of consumables and use of the medical equipment, the hospital controls the right to direct the use of the asset. The results of the useful-life test reveal that the lease of the medical equipment should be accounted for as a sales-type lease by the lessor. The medical device owner would therefore be required to record a day 1 loss for the arrangement, as indicated in the following journal entries:

Net investment in lease	500,000	
Loss on sales-type lease	9,500,000	
Medical equipment		10,000,000

The FASB issued ASU 2021-05 to address the uneconomic outcome illustrated above. The amendments in the ASU affect only lessor accounting and will have no impact on lessees.

### 11.2.1.2 Key Provisions

ASC 842-10-25-3A (added by ASU 2021-05) requires a lessor to classify a lease with variable payments as an operating lease at lease commencement if both of the following conditions are met:

- The lease would have been classified as a sales-type lease or direct financing lease in accordance with the classification criteria in ASC 842-10-25-2 and 25-3, respectively.
- The lessor would have recognized a selling loss at lease commencement.

When applying the guidance in ASC 842-10-25-3A, the lessor would not derecognize the underlying asset upon lease commencement but would continue to depreciate the underlying asset over its useful life. Further, in accordance with ASC 842-30-25-11(a), the lessor would recognize fixed lease payments as “income . . . over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset.” Variable lease payments would be recognized as “income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur,” as indicated in ASC 842-30-25-11(b).

Note that the ASU does not prescribe a threshold for the amount of variable payments; for an entity to apply the ASU’s guidance, a lease only needs to contain some amount of variable payments.



### Connecting the Dots

We expect that under ASU 2021-05, more lessors will be required to classify leases as operating leases rather than as sales-type leases or direct financing leases. Accordingly, additional leases will qualify for the lessor practical expedient in ASC 842-10-15-42A,<sup>6</sup> which allows lessors to combine lease and nonlease components into a single component if certain scope requirements are met. One of these requirements is that the underlying lease component must be classified as an operating lease. Therefore, as a result of the ASU, additional leases will qualify for the lessor practical expedient.

#### 11.2.1.3 Effective Date and Transition

Lessors that did not adopt ASC 842 on or before July 19, 2021, should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-05. Those entities should adopt the ASU on the same date on which they adopt ASC 842.

Lessors that have adopted ASC 842 as of July 19, 2021, should apply the transition requirements for fiscal years beginning after December 15, 2021.<sup>7</sup> Entities should use either of the following approaches to apply the ASU’s amendments:

- Retrospective application to leases that commence or are modified on or after the adoption of ASC 842, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).
- Prospective application to leases that commence or are modified on or after the date on which a lessor first applies the amendments in ASU 2021-05, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).

An entity is permitted to early adopt ASU 2021-05 as long as it does not do so before adopting ASC 842.

<sup>6</sup> ASC 842-10-15-42A, as amended by ASU 2021-05, states, “As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A.”

<sup>7</sup> For PBEs and entities within the scope of ASC 842-10-65-1(a), ASU 2021-05 is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other entities within the scope of ASC 842-10-65-1(b), the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

## 11.2.2 ASU 2021-09 on the Discount Rate for Lessees That Are Not PBEs

### 11.2.2.1 Background and Key Provisions

In November 2021, the FASB issued [ASU 2021-09](#), which allows lessees that are not PBEs to make an accounting policy election by class of underlying asset, rather than on an entity-wide basis, to use a risk-free rate as the discount rate when measuring and classifying leases.

Before the issuance of ASU 2021-09, ASC 842-20-30-3 permitted non-PBE lessees to “use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election **for all leases**” (emphasis added). However, during the two public roundtables that the FASB held in September 2020 to discuss challenges with implementing ASC 842, the Board learned that many entities would not benefit from electing this practical expedient because such entities did not want to use the risk-free rate for **all** of their leases for which they are a lessee. In response, private-company stakeholders proposed a more practicable alternative that would allow lessees to elect to use the risk-free rate as their discount rate for certain classes of underlying assets, as opposed to only having the option of making that election at an entity-wide level.<sup>8</sup>

In addition to allowing lessees to elect to use the risk-free rate as an accounting policy by asset class rather than on an entity-wide level, ASU 2021-09 requires lessees to:

- Disclose their election, including the asset class(es) for which they have elected the accounting policy.<sup>9</sup>
- Use the rate implicit in the lease instead of the risk-free rate when the former is readily determinable, regardless of whether the practical expedient has been elected.

### 11.2.2.2 Effective Date and Transition

Lessees that did not adopt ASC 842 on or before November 11, 2021, should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-09. The ASU should be adopted on the same date on which an entity adopts ASC 842.

Lessees that have adopted ASC 842 as of November 11, 2021, should apply the transition requirements described in the ASU.

Early adoption of ASU 2021-09 is permitted, as long as an entity does not adopt the ASU before adopting ASC 842.

For more information about ASU 2021-09, see Deloitte’s November 12, 2021, [Heads Up](#).

<sup>8</sup> ASC 842 does not address what is meant by the phrase “class of underlying asset.” Before ASU 2021-09, entities were allowed to make other accounting policy elections by class of underlying asset, so entities may already have policies in place on how they define asset class. See [Section 4.3.3.1](#) of Deloitte’s Roadmap [Leases](#) for information about applying this concept.

<sup>9</sup> As amended by the ASU, ASC 842-20-50-10 states, “A lessee that makes the accounting policy election in paragraph 842-20-30-3 to use a risk-free rate as the discount rate shall disclose its election and the class or classes of underlying assets to which the election has been applied.”

## 11.2.3 ASU 2023-01 on Common-Control Arrangements

### 11.2.3.1 Background and Key Provisions

In March 2023, the FASB issued [ASU 2023-01](#), which amends certain provisions of ASC 842 that apply to arrangements between related parties under common control. Specifically, the ASU:

- Offers private companies, as well as NFPs that are not conduit bond obligors, a practical expedient that gives them the option of using the written terms and conditions of a common-control arrangement when determining whether a lease exists and the subsequent accounting for the lease, including the lease's classification.
- Amends the accounting for leasehold improvements in common-control arrangements for all entities.

#### 11.2.3.1.1 Practical Expedient That Allows the Evaluation of Written Terms and Conditions of a Common-Control Arrangement

ASC 842 requires entities to determine whether a related-party arrangement between entities under common control is a lease on the basis of the legally enforceable terms and conditions of the arrangement. The accounting for a lease depends on the enforceable rights and obligations of each party as a result of the contract. This principle applies irrespective of whether such rights or obligations are included in the contract or explicitly or implicitly provided outside of the contract (i.e., there may be enforceable rights or obligations that extend beyond the written lease contract).

As part of the FASB's postimplementation review of ASC 842, private companies asserted that this requirement creates unnecessary cost and complexity for financial statement preparers, since the terms and conditions of such common-control lease arrangements may lack sufficient details, may be uneconomic, or may be changed without approval, given that one party in the common-control group generally controls the arrangement. Therefore, stakeholders have indicated that it is challenging to determine the legally enforceable terms and conditions of these arrangements and that legal counsel may need to be involved in making this determination, thereby incurring additional cost.

In response to that feedback, ASU 2023-01 provides an optional practical expedient under which private companies, as well as not-for-profit entities that are not conduit bond obligors, can use the written terms and conditions of an arrangement between entities under common control to determine (1) whether a lease exists and (2) the subsequent accounting for (and classification of) the lease. This practical expedient can be applied on an arrangement-by-arrangement basis, and an entity is not required to consider the legal enforceability of such written terms and conditions. However, if no written terms and conditions of an arrangement between entities under common control exist, an entity is not allowed to elect the practical expedient and is required to apply ASC 842 in a manner consistent with how it is applied to other arrangements.

#### 11.2.3.1.2 Accounting for Leasehold Improvements in Common-Control Arrangements

Under ASC 842, a lessee is generally required to amortize leasehold improvements that it owns over the shorter of the useful life of those improvements or the lease term. As part of the FASB's postimplementation review of ASC 842, private-company stakeholders have noted that in a lease arrangement between entities under common control, the amortization requirements of ASC 842 are inconsistent with the underlying economics of the arrangement since (1) the lessee may continue to control the use of the underlying asset after the lease term and (2) another party in the common-control group may benefit from the leasehold improvements after the lessee no longer controls the use of the underlying asset.

In response to that feedback, ASU 2023-01 requires a lessee in a common-control lease arrangement to amortize leasehold improvements that it owns over the improvements' useful life to the common-control group, regardless of the lease term, if the lessee continues to control the use of the underlying asset through a lease. This amendment applies to all entities.

In situations in which a lessee obtains control of an underlying asset through a lease with an unrelated party not under common control and subsequently subleases the asset to an entity under common control, the sublessee would generally amortize the leasehold improvements over a period that does not exceed the term of the lease between the lessee/intermediate lessor and the unrelated party. However, if the lease between the lessee/intermediate lessor and the unrelated party contains an option to purchase the underlying asset and the lessee/intermediate lessor is reasonably certain to exercise that option, the leasehold improvements should be amortized over the useful life to the common-control group.

Further, a lessee that no longer controls the use of the underlying asset will account for the transfer of the underlying asset as an adjustment to equity (i.e., as with a transfer of assets between entities under common control).

For more information about ASU 2023-01, see Deloitte's March 28, 2023, [Heads Up](#).

### **11.2.3.2 Effective Date and Transition**

ASU 2023-01 is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted in any annual or interim period as of the beginning of the related fiscal year.

In relation to the practical expedient offered by ASU 2023-01, entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 must apply the transition requirements of ASU 2016-02. Entities that have adopted ASC 842 before the effective date of ASU 2023-01 can apply the amendments in either of the following ways:

- Prospectively to arrangements that commence or are modified on or after when the entity first applies ASU 2023-01.
- Retrospectively to the beginning period in which an entity applied ASC 842 for arrangements that existed as of the adoption date of ASU 2023-01. The practical expedient cannot be applied to common-control arrangements that no longer exist as of the adoption date.

Regarding the amendment related to accounting for leasehold improvements in common-control arrangements, entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 may apply the transition requirements of ASU 2016-02. However, entities that elect to retrospectively apply ASU 2016-02 to the beginning period of adoption are allowed to apply either of the prospective approaches described below to avoid retrospectively accounting for leasehold improvements associated with common-control leases.

Entities that have adopted ASC 842 before the effective date of ASU 2023-01 have the option of using one of the following adoption methods:

- Prospective application to all new leasehold improvements recognized on or after the date on which the entity first applies the amendments in ASU 2023-01.
- Prospective application to all new and existing leasehold improvements recognized on or after the date on which the entity first applies the amendments in ASU 2023-01, with any remaining balance of leasehold improvements amortized over their remaining useful life to the common-control group determined as of that date.
- Retrospective application to the beginning of the period in which an entity first applied ASC 842, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to opening retained earnings at the beginning of the earliest period presented in accordance with ASC 842.

### 11.3 SEC Comment Letter Themes Related to Leases

The focus of the SEC staff's comments on leasing transactions is shifting from registrants' accounting under the legacy leasing guidance (codified in ASC 840) to their application of the new leasing standard. Although relatively few SEC staff comments on the application of ASC 842 have been issued thus far, some observations in comments related to its application have emerged. For example, registrants have received comments on (1) how ASC 842 applies or does not apply in certain arrangements and (2) the discount rate used to calculate the amount of the lease liability and corresponding ROU asset. Other topics addressed in SEC staff comments on ASC 842 include, but are not limited to, the nature of expenses treated as initial direct costs; the determination of lease classification; accounting for leasehold improvements, including amortization; and impairment considerations related to ROU assets. Given the relatively low volume of SEC staff comments related to ASC 842 that have been issued thus far, registrants should continue monitoring staff comments to identify any new comments or trends related to the new leasing standard that may emerge in the future.

For more information about SEC comment letter themes that are relevant to life sciences companies, see Deloitte's Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#). In addition, see Deloitte's January 7, 2020, [Heads Up](#), which outlines the ASC 842 disclosure requirements, elaborates on some of those requirements, and provides examples of related SEC comments issued to registrants.

# Appendix B — Titles of Standards and Other Literature

## AICPA Literature

### Accounting and Valuation Guides

*Assets Acquired to Be Used in Research and Development Activities*

*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*

### Clarified Statements on Auditing Standards

AU-C Section 501, "Audit Evidence — Specific Considerations for Selected Items"

AU-C Section 620, "Using the Work of an Auditor's Specialist"

## FASB Literature

### ASC Topics

ASC 105, *Generally Accepted Accounting Principles*

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 440, *Commitments*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 832, *Government Assistance*



ASC 835, *Interest*  
 ASC 840, *Leases*  
 ASC 842, *Leases*  
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 ASC 855, *Subsequent Events*  
 ASC 860, *Transfers and Servicing*  
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 ASC 930, *Extractive Activities — Mining*  
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 ASC 946, *Financial Services — Investment Companies*  
 ASC 948, *Financial Services — Mortgage Banking*  
 ASC 954, *Health Care Entities*  
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## Appendix C — Abbreviations

Abbreviation	Description
<b>AETR</b>	annual effective tax rate
<b>AFS</b>	available for sale
<b>AFSI</b>	adjusted financial statement income
<b>AI</b>	artificial intelligence
<b>AICPA</b>	American Institute of Certified Public Accountants
<b>AIN</b>	AICPA Accounting Interpretation of an APB Opinion
<b>AMT</b>	alternative minimum tax
<b>ANDA</b>	abbreviated new drug application
<b>APB</b>	Accounting Principles Board
<b>API</b>	active pharmaceutical ingredient
<b>ARO</b>	asset retirement obligation
<b>ASC</b>	FASB Accounting Standards Codification
<b>ASR</b>	accelerated share repurchase
<b>ASU</b>	FASB Accounting Standards Update
<b>AUD</b>	Australian dollar
<b>BCF</b>	beneficial conversion feature
<b>BEAT</b>	base erosion anti-abuse tax
<b>BEMTA</b>	base erosion minimum tax amount
<b>BPD</b>	branded prescription drug
<b>C&amp;Dis</b>	Compliance and Disclosure Interpretations
<b>CAM</b>	critical audit matter
<b>CAQ</b>	Center for Audit Quality
<b>CARES Act</b>	Coronavirus Aid, Relief, and Economic Security Act
<b>CCF</b>	cash conversion feature

Abbreviation	Description
<b>CECL</b>	current expected credit loss
<b>CFC</b>	controlled foreign corporation
<b>CIMA</b>	Chartered Institute of Management Accountants
<b>CMO</b>	contract manufacturing organization
<b>CRO</b>	contract research organization
<b>CSRD</b>	Corporate Sustainability Reporting Directive
<b>DTA</b>	deferred tax asset
<b>DTL</b>	deferred tax liability
<b>EBITDA</b>	earnings before interest, taxes, depreciation, and amortization
<b>ED</b>	exposure draft
<b>EDGAR</b>	SEC electronic data gathering, analysis, and retrieval system
<b>EGC</b>	emerging growth company
<b>EITF</b>	Emerging Issues Task Force
<b>ELOC</b>	equity line of credit
<b>EPS</b>	earnings per share
<b>ESA</b>	energy service agreement
<b>ESG</b>	environmental, social, and governance
<b>ESPP</b>	employee stock purchase plan
<b>ESRS</b>	European Sustainability Reporting Standards
<b>EUR</b>	euros
<b>Exchange Act</b>	Securities Exchange Act of 1934
<b>FASB</b>	Financial Accounting Standards Board
<b>FAST Act</b>	Fixing America's Surface Transportation Act

Abbreviation	Description
<b>FDA</b>	U.S. Food and Drug Administration
<b>FDII</b>	foreign-derived intangible income
<b>FOB</b>	free on board
<b>FPI</b>	foreign private issuer
<b>FRM</b>	SEC Division of Corporation Finance Financial Reporting Manual
<b>FVO</b>	fair value option
<b>FVTOCI</b>	fair value through other comprehensive income
<b>GAAP</b>	generally accepted accounting principles
<b>GenAI</b>	generative artificial intelligence
<b>GHG</b>	greenhouse gas
<b>GILTI</b>	global intangible low-taxed income
<b>GloBE</b>	Global anti-Base Erosion
<b>GPO</b>	group purchasing organization
<b>HAFWP</b>	how and for what purpose
<b>HFI</b>	held for investment
<b>HFS</b>	held for sale
<b>HVAC</b>	heating, ventilation, and air conditioning
<b>IAS</b>	International Accounting Standard
<b>IASB</b>	International Accounting Standards Board
<b>IBNR</b>	incurred but not reported
<b>ICFR</b>	internal control over financial reporting
<b>IFRIC</b>	IFRS Interpretations Committee
<b>IFRS</b>	International Financial Reporting Standard
<b>IIR</b>	investigator-initiated research
<b>IP</b>	intellectual property
<b>IPO</b>	initial public offering
<b>IPR&amp;D</b>	in-process research and development
<b>IRC</b>	Internal Revenue Code
<b>IRS</b>	Internal Revenue Service
<b>ISO</b>	incentive stock option

Abbreviation	Description
<b>ISSB</b>	International Sustainability Standards Board
<b>IT</b>	information technology
<b>ITC</b>	invitation to comment
<b>JOBS Act</b>	Jumpstart Our Business Startups Act
<b>LCD</b>	liquid-crystal display
<b>LIBOR</b>	London Interbank Offered Rate
<b>LIFO</b>	last in, first out
<b>M&amp;A</b>	merger and acquisition
<b>MD&amp;A</b>	Management's Discussion & Analysis
<b>MNE</b>	multinational enterprise
<b>MSL</b>	medical science liaison
<b>NDA</b>	new drug application
<b>NFP</b>	not-for-profit (entity)
<b>NIH</b>	National Institutes of Health
<b>NOL</b>	net operating loss
<b>NOPA</b>	notice of proposed adjustment
<b>NQSO or NSO</b>	nonqualified stock option
<b>OCA</b>	SEC's Office of the Chief Accountant
<b>OCI</b>	other comprehensive income
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OEM</b>	original equipment manufacturer
<b>PBE</b>	public business entity
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PCC</b>	Private Company Council
<b>PIPE</b>	private investment in public equity
<b>PP&amp;E</b>	property, plant, and equipment
<b>PRV</b>	priority review voucher
<b>PTRS</b>	probability of technical and regulatory success
<b>Q&amp;A</b>	question and answer
<b>QIP</b>	qualified improvement property

Abbreviation	Description
<b>R&amp;D</b>	research and development
<b>R&amp;E</b>	research and experimental
<b>REC</b>	renewable energy certificate
<b>REMS</b>	risk evaluation and mitigation strategy
<b>RIM</b>	retail inventory method
<b>ROU</b>	right of use
<b>SaaS</b>	software as a service
<b>SAB</b>	Staff Accounting Bulletin
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>Securities Act</b>	Securities Act of 1933
<b>SEPA</b>	standby equity purchase agreement
<b>SOX</b>	Sarbanes-Oxley Act of 2002
<b>SPAC</b>	special-purpose acquisition company

Abbreviation	Description
<b>SPPI</b>	solely payments of principal and interest
<b>SRC</b>	smaller reporting entity
<b>S&amp;P 500</b>	Standard & Poor's 500 Index
<b>TD</b>	Treasury Decision
<b>TDR</b>	troubled debt restructuring
<b>TRG</b>	transition resource group
<b>TRWG</b>	IFRS Foundation Technical Readiness Working Group
<b>TSA</b>	transition services agreement
<b>USD</b>	U.S. dollars
<b>UTB</b>	unrecognized tax benefit
<b>VIE</b>	variable interest entity
<b>VWAP</b>	volume-weighted average daily market price
<b>XBRL</b>	eXtensible Business Reporting Language

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