

## ASC 842: UNDERSTANDING EMBEDDED LEASES

An embedded lease is a component contained within a larger agreement that provides for the use of an asset. Under ASC 842, embedded leases have these components:

1. The asset is identifiable. The specific asset is implicitly or explicitly identified in the contract. If the lessor can unilaterally substitute or replace the asset, there probably is not an embedded lease.
2. The lessee has the right to control the asset. The lessee must have the right to use and control the asset or have the ability to direct how the asset is used.
3. The lease term is for a specific period. The term of the lease must be for a set period of time.
4. Consideration was exchanged. The lessee must pay the lessor to use or control the asset.

A big challenge under the new standard will be to identify embedded leases that can often be buried in other types of agreements such as:

- ▶ **Service agreements.** If the service agreement identifies a specific asset, there probably is an embedded lease. For example, suppose a construction company contracts with a transportation service provider to deliver heavy equipment or materials to its site. If the contract requires the service provider to use specific vehicles, there is probably an embedded contract.
- ▶ **Equipment rental agreements.** Identifying embedded leases in equipment agreements largely depend on whether the asset is identifiable, who has control over the asset, and whether the asset is easily replaceable with a similar asset. The answers will determine whether the contract contains an embedded lease.
- ▶ **Manufacturing contracts.** Construction companies that contract with manufacturers must review their contracts for certain elements: Is the equipment being used to fabricate the requested items being used to fabricate items for other customers? Could the equipment used in the fabrication be used to produce other products?
- ▶ **Transportation/logistics contracts.** Contracts with transportation and logistics companies (e.g., railcars or barges used to move materials) may contain embedded leases. Here, relevant questions include whether the transportation equipment is used when not used within the parameters of the contract and whether they are used to transport materials for other companies.

In addition to these four types of agreements, embedded contracts may be found in supply agreements, advertising contracts, managed services and information technology agreements. Essentially, nearly every type of contract may contain an embedded lease even if the lease does not specifically say “lease” or “rent.”



Embedded leases may be found in service agreements, equipment rental agreements, manufacturing contracts and transportation/logistics contracts.

## HAVE QUESTIONS?

Adams Brown, Strategic Allies and CPAs, provides a wide range of traditional and specialized CPA and consulting services to construction businesses, contractors and sub-contractors across the nation. The firm has a specialized, diverse team of experts immersed in the industry that holistically serves construction leadership teams. To learn more, contact Mark P. Barnett, Jr., CPA, CVA, CGMA, CCIFP, MBA, Construction Industry Leader, at [MBarnett@AdamsBrownCPA.com](mailto:MBarnett@AdamsBrownCPA.com) or 870.520.6215.

# 16 STEPS TO TAKE IN PREPARATION OF ASC 842 ADOPTION

1

Gather all contracts in one place

2

Review all contracts for previously unknown leases (e.g., embedded, in substance leases)

3

Review general ledger for expense account activity

4

Review reoccurring vendor payments for service or supply contracts

5

Review complete and in process projects to ensure that future amortization of any embedded leases is considered

6

Review reoccurring vendor payments for service or supply contracts

7

Inventory identified leases according to significant lease terms (e.g., purchase, renewal or cancellation options, initial direct costs)

8

Document procedures used to identify leases

9

Determine policy elections and practical expedients

10

Assess whether existing systems, internal controls, and processes are adequate

11

Draft new lease accounting policy outlining how policy elections and practical expedients will affect financial statements

12

Determine whether lease accounting software is needed; if it is, review vendor options; finalize software selection

13

Upload lease details, including applicable historical transactions, into lease accounting software

14

Manually test to ensure accuracy of software

15

Prepare new disclosures

16

Review all processes and procedures with accountant/auditor to ensure compliance