CONSTRUCTION ISSUE SHEET

LEASES

OVERVIEW OF HOW ASC 842 IMPACTS CONSTRUCTION COMPANIES

Under ASC 840, the prior leasing standard, construction companies were able to disclose their leases in the financial statement footnotes rather than on their financials. In effect, this practice prevented investors, vendors, government agencies and business stakeholders from having a clear picture of the company's true financial picture or exposure to risk. The FASB issued ASC 842 to increase transparency and allow interested parties to compare the results of different companies.

ASC 842 requires changes to how companies report leases on their financial statements. As a result, the present market value of the asset must be included on the company's balance sheet under the assets side, and depreciation must be charged on the income statement. Consequently, construction companies must:

- Record all operating and finance leases on their balance sheets. In practical terms, this means construction companies must now report right-of-use (ROU) assets and liabilities on their balance sheets.
- Classify all leases as either operating leases or finance leases on the company's income statements.
    - Operating leases must be recorded as straight-line rental expense (similar to current operating leases).
    - Finance leases must be reported as an interest expense determined under the effective interest method.

Adoption of ASC 842 is mandatory and will be effective for all private companies, including construction companies, for fiscal years beginning after December 15, 2021. This means that private companies reporting on a calendar year must adopt ASC 842 effective January 1, 2022, since their first calendar year-end reporting date will be December 31, 2022. Keep in mind that ASC 842 does not (1) grandfather existing leases or (2) require most short-term leases (i.e., leases with a term of 12 months or less) to be reported.

HISTORICAL PERSPECTIVE

Prior to ASC 842, most construction companies used operating lease arrangements to obtain the fixed assets they needed to operate without expending cash or taking on debt. These arrangements were considered off-balance sheet transactions that were only reported in the company's financial statement footnotes. Now that operating leases must be recorded on the company's financial statements, the benefit of not reporting any resulting liabilities on the balance sheet is lost. As a result, construction companies need to consider whether to (1) structure their leases as finance or operating leases or (2) purchase an asset rather than leasing it.

Construction companies will find that the requirements of ASC 842 significantly change how they account for embedded leases, related party leases and consolidated leases, especially when there is a variable interest entity. Bank and surety considerations will also be impacted.

ALL ACCOUNTING PROCESSES REQUIRE REVIEW

These changes affect accounting processes across all company operations and will require an extensive review of how the company reports real estate leases, equipment leases, procurement, and tax, for example.

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Companies should prepare for implementing ASC 842 by taking these steps:

1. Reviewing all contracts and other agreements to identify, for example, embedded or in substance leases, fixed and variable payments, payment term, purchase option, initial direct costs and option to renew or cancel.

2. Collecting information from as many sources as possible, such as local offices, job sites, plants and distribution centers to verify information.

3. Evaluating contracts to determine classification: operating lease or financing lease.

4. Considering available (1) policy elections, (2) practical expedients, (3) separate elections and (4) financial statement adoption options.

5. Updating existing company policies and procedures, including internal controls, to reflect ASC 842 requirements.

The review process can be quite complicated and time-consuming. Consequently, most companies will find it helpful to consider implementing third party leasing software to assist with the task.

Note that the AICPA has published the 2021 Construction Contractors: Audit and Accounting Guide that includes sample financial statements reflective of all guidance effective as of the date of the guide. Within the sample financial statements, there are examples of the effects on the financial statement and footnote disclosures that are required upon adoption of ASC 842. Refer to this guide as well as other public company financial reports that have already implemented this standard when preparing company financial statements under ASC 842

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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 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