



ASC 842: UNDERSTANDING LEASE MODIFICATIONS

A lease modification is any change to a contract's terms and conditions that results in a change in a lease's scope or consideration. Accounting for lease modifications is complicated. Such modifications generally require the lease liability to be remeasured using a discount rate determined at the modification's effective date if the contract modification:

- ▶ Grants the lessee an additional ROU not included in the original contract
- ▶ Extends or reduces the term of an existing lease
- ▶ Fully or partially terminates an existing lease
- ▶ Changes only the contract consideration

Separate Contract

Lease modifications are treated as separate contracts if:

1. The modification grants the lessee an ROU not specified in the original lease
2. Lease payments required for the additional ROU are consistent with the standalone price for the additional ROU, including adjustments for conditions that may be unique to the contract

In effect, this means lease modifications are accounted for as separate contracts if the modification grants the lessee an additional ROU asset not included in the original lease.

Not a Separate Contract

If the lease modification does meet the requirements for being classified as a separate contract, the lessee must remeasure the lease liability and ROU asset as of the modification date. The terms that must be reassessed are:

- ▶ Lease term and purchase options
- ▶ Discount rate
- ▶ Allocation of consideration
- ▶ Lease classification

Full or Partial Contract Termination

If the modified terms of the lease agreement reduce the lessee's rights to the underlying asset, it is accounted for as a partial or full contract termination.

- ▶ **Full termination:** The lessee removes the outstanding lease liability and ROU asset from their books. If the carrying value of the ROU asset does not equal the lease liability balance at the termination date, the lessee recognizes a gain or loss through the income statement in the period of termination for the amount of difference.
- ▶ **Partial termination:** If the lease modification only partially reduces the lessee's rights to the underlying asset(s), this is accounted for as a partial termination. The lease liability is remeasured based on the new payment terms, and the ROU asset is reduced based on either the proportionate change in the lease liability or the proportionate change in the asset.



Continued on next page.



ASC 842: UNDERSTANDING LEASE MODIFICATIONS,

continued from previous page.

COVID-19 Accommodation

The COVID-19 pandemic resulted in an unexpected number of lease modifications. In April 2020, the FASB provided an electable alternative to requiring entities to treat lease concessions as lease modifications.

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