CONSTRUCTION ISSUE SHEET

LEASES

ASC 842: POLICY AND PRACTICAL EXPEDIENT CONSIDERATIONS

A practical expedient is an accounting policy election allowed by the FASB that provides relief from the burden on financial statement preparers to apply the requirements of an accounting standard. ASC 842 provides for several practical expedients, some providing relief in initial application and others simplifying ongoing compliance.

The policies and practical expedients companies elect as they make the transition from ASC 840 to ASC 842 have long-term effects on the company's reporting going forward, so it is important to get input from accountants and advisors with expertise helping construction companies make these critical choices.

The available practical expedient elections include:

1. Effective date method or comparative method

Using the effective date method, companies must record any cumulative adjustments related to ASC 842 as of the date of implementation. Prior year information presented in the financial statements does not have to be adjusted.

Companies electing the comparative method must record cumulative adjustments related to the implementation of ASC 842 as of the opening date of the earliest comparative period presented in the financial statements.

While the effective date method is generally less time consuming and less expensive to implement, it may not be the best choice for all companies since some lenders may require comparative data.

2. Evaluation of leases at date of transition

The leases at date of transition expedient must be elected as a package (i.e., all three elements of this expedient (a, b and c below) must be accepted as a package) and applied consistently to each of the entity's leases.

A. ***Existing or expired contracts.*** If this expedient is not elected, every contract would have to be evaluated and examined to determine whether they contain a lease or a lease component.

B. ***Reevaluating existing lease classifications.*** This part of the expedient considers:

- Existing leases that were previously classified as operating leases to automatically be classified as operating leases.
- Existing leases that were classified as capital leases to automatically be classified as finance leases.
- With these stipulations:
  - Reclassification of an operating lease under ASC 840 deemed to meet the criteria of a finance lease requires the entity to make changes to a whole class of similar leases in the income statement
  - Reclassification of an operating lease under ASC 840 to an operating lease under ASC 842 has no effect on the income statement.
  - Both reclassifications must be recognized on the balance sheet as right-of use assets and lease liabilities

C. ***Evaluating the existence of indirect costs for existing leases.*** Certain outlays classified as initial direct costs under ASC 840 do not have to be reevaluated. ASC 842 defines initial direct costs as those that could have been avoided had the entity not entered into a lease agreement

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3. Use of hindsight

Entities may elect a practical expedient to use hindsight in determining the lease term and in assessing the impairment of the entity's right-of- use assets.

4. Accounting policy for short-term leases

Lessees make elect not to record a ROU assets and lease liabilities for short- term leases (i.e., leases with a lease term of 12 months or less). Such leases would be recorded similarly to operating leases under ASC 840, with the lease payments being recognized into profit or loss on a straight-line basis over the lease term.

5. Risk-free rate for private entities, not-for-profit organizations, and employee benefit plans

Privately-held companies may elect to use a risk-free rate (e.g., U.S. Treasury bill rate) as the discount rate to classify and measure leases by class of underlying asset. If this election is made, the entity would have to report a larger liability associated with the ROU asset.

Note that lessees must use the rate implicit in the lease for any individual lease when it is readily determinable, regardless of whether it has made the risk-free rate election.

6. Consideration paid for contracts with lease and non-lease components

This practical expedient allows lessees to treat each lease component and its related non-lease components as a single lease component.

The same relief is granted to lessors if both of the following conditions are met:

- The timing and pattern of transfer for the lease component and associated non- lease components are the same.
- The lease component, if accounted for separately, would be classified as an operating lease.

7. Cumulative Adjustment and Separating Components

Entities may record a cumulative adjustment to the opening balance of retained earnings in the year of adoption. Lessors may elect not to separate non-lease components from their related lease components.

8. Variable Interest Entities (VIEs)

Private companies that previously elected out of consolidating balances of VIEs under previous guidance may want to pay attention to the changes brought by ASC 842. Companies that opted out of applying VIE guidance to all legal entities under common control need to consider that if the VIE leasing arrangement qualifies as an operating or financing lease under ASC 842 may end up having to calculate and report ROU assets and lease obligation liabilities in a separate supplementary report.

9. Land easement

A land easement consists of a right to use and/or enter land owned by another party. Construction companies that elect this expedient do not have to reassess whether any existing or expired land easements at the time of implementation of ASC 842 meet the definition of a lease.

Each of these practical expedients has pros and cons, advantages and disadvantages. Companies should carefully examine each practical expedient with input from their financial advisors before making an election.

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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.

POLICY AND PRACTICAL EXPEDIENT CONSIDERATIONS:

1. Effective date method or comparative method
2. Evaluation of leases at date of transition
3. Use of hindsight
4. Short-term leases
5. Risk-free rates
6. Single lease
7. Cumulative adjustment
8. VIEs
9. Land easements

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