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# Get Ready for the New Lease Standard

By Robert Mercado and Michelle Johnson | Monday, December 14, 2020
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Even while contractors are in the process of modifying their financial reporting to the specifications of new revenue recognition standard Topic 606, another new standard is pending and expected to have an even more significant impact on construction businesses: ASU 842—Leases. This new lease standard will be in effect for all private companies with year-ends beginning after Dec. 15, 2021. ASU 842 originally was set to take effect for December 2020 year-ends, but was deferred due to the pandemic. Contractors should consider this a gift that allows time to understand how management and outside credit-extending companies will view their financial statements under the new standard.

## CURRENT LEASE STANDARD

The current lease standard, ASC 840, covers two types of leases: operating and capital. Operating leases are not shown as an asset or a liability on the company's balance sheet. Operating lease payments are recognized, under a straight-line method, as rent or lease expense on the company's income statement.

Capital leases are recorded as long-term assets, included with the company's fixed assets on the balance sheet. In addition, corresponding future capital lease payments—discounted for future interest that will be recorded as payments are made—are broken out and shown as current and long-term liabilities on the company's balance sheet. As payments are made on a capital lease, future lease payments on the balance sheet are reduced at the discounted rate, and interest is charged as an expense on the income statement. The leased asset on the balance sheet is amortized, on a straight-line basis over the life of the term of the lease, as an amortization expense on the income statement.

## NEW LEASE STANDARD

Under ASU 842, capital leases will be referred to as financing leases. In addition, the leased asset will no longer be included in fixed assets but will now be a "financing lease right-to-use" asset. It will remain as a long-term asset on the company's balance sheet. There will be relatively no change to reporting on the income statement for financing leases.

Most impacted by ASU 842 will be operating leases. Operating leases in excess of 12 months will now be shown on the balance sheet under long-term assets as an “operating lease right-to-use asset.” This burdens the corresponding current and long-term portion of the lease obligation related to the operating lease, based on the present value of the future minimum lease payments consistent with how financing leases are shown.

There are marked differences between an operating lease and a financing lease. These differences are seen in the income statement. The operating lease right-to-use asset is amortized as a rent or lease expense on the income statement using the straight-line method—not an amortization expense, as with a financing lease. In addition, the interest that would be charged on the operating lease obligation is included in the rent or lease expense on the income statement.

## DEFINITION OF A LEASE

The new standard also introduces new criteria for what constitutes a lease. ASU 842 defines a lease as a contract, or part of a contract, that conveys the right to control the use of the identified property plant or equipment for a period of time in exchange for consideration. A “contract,” as referred to in the definition of “lease,” is (or contains) a lease when the following two criteria are met:

1. The contract explicitly or implicitly specifies the use of an identifiable asset; and
2. The customer controls the use of the asset for that period of use.

## OPERATING VERSUS FINANCING

If it is determined that the contract is a lease, it is now necessary to classify whether it is an operating or financing lease. If the lease meets any of the following criteria, it is a financing lease:

- Transfers ownership of the underlying asset;
- Grants the option to purchase the underlying asset, and the lessee is reasonably certain to exercise that option;
- The lease term covers a major part of the remaining economic life of the underlying asset;
- Present value of lease payments, and any additional residual value guarantee by the lessee, equal or exceed substantially all or more of the fair value of the underlying asset; or
- Underlying asset is specialized in nature with no alternative use to the lessor at the end of the lease.

For financing leases, this will have no impact on financial statements. However, for operating leases, it will have a significant impact on the contractor's financial statements.

Historically, lease obligations were disclosed in the notes of the financial statement. ASU 842 now requires recording future discounted lease payments on the balance sheet as a lease obligation. This impacts the various ratios on which management and outside lending parties base decisions about the extension of credit. Ratios to be considered include working capital, total liabilities to equity and debt coverage. It is anticipated that these ratios and potentially others will need revision to address this change in the new lease standard.

## EMBEDDED LEASES

Contractors need to exercise caution in entering into contracts that may appear as normal rental agreements; if they fall under the ASU 842 standard, they are referred to as "embedded leases." This is something contractors must pay attention to as it may significantly impact their financial statements.

An embedded lease may play a significant role for contractors that have large equipment rental agreements. For example, if a general contractor is constructing a building that will take two years to build, it enters into a rental agreement with the crane company for the equipment and the crane operator. As the building is constructed, the crane will be an identifiable asset being leased, with the general contractor having control over the use of the crane and the operator of the crane while the building is under construction. Under the current standard, the monthly rental of the crane and the operator is charged to the project on a monthly basis. Under the new standard, the general contractor would be required in this scenario to record an operating lease right-to-use asset and corresponding lease obligation for the entire two years of the lease, and to amortize the lease cost over the term of the lease. This is now debt on the contractor's financial statement that was previously not recorded.

## CONCLUSION

It behooves contractors to take advantage of the extension before ASU 842 takes effect, to thoroughly research the new lease accounting standard. Being prepared for the potential impact of ASU 842 on contractors' financial statements will help mitigate the effect on the ratios used by management and outside parties to make decisions and, potentially, on the extension of credit.

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