Effect of the New ASU 842 Leasing Standard


Mercado


Johnson

By Robert Mercado and Michelle Johnson

Robert Mercado is the New England regional construction leader at Marcum LLP, a top-ranked national accounting and advisory services firm based in New Haven, Connecticut. He can be reached at robert.mercado@marcumllp.com.
Michelle Johnson is a senior manager in Marcum LLP's Assurance Services group. She can be reached at michelle.johnson@marcumllp.com.

Accounting rules are undergoing a sea change in an ongoing effort to create more transparency, particularly for the users of financial information, such as banks and sureties.

One of the biggest changes is the impending implementation of ASU 842 – Leases (ASU-842), set to replace the current lease standard, ASU 840, for non-public companies with years beginning after Dec. 15, 2021; that is, companies with year ends of Dec. 31, 2022, or later. The new standard has already taken effect for public companies.

Although implementation for non-public companies has been extended several times, there doesn't appear to be another extension on the horizon. Companies need to start now in order to be ready.

One of the biggest changes under ASU-842 is that companies will be required to recognize assets and liabilities arising from operating leases. Under the current ASU-840 standard, operating leases are not recorded on the balance sheet; they are footnoted and expensed as payments are made.

Once ASU 842 takes effect, all leases, including operating and financing leases (formerly capital leases) with terms longer than 12 months will be recognized on the balance sheet as an asset and a liability.

ASU 842 defines a lease as a contract conveying the right to control the use of identified property, plant, or equipment ("identified asset") for a period of time in exchange for consideration. A contract is (or contains) a lease when two criteria are met: (1) The contract explicitly or implicitly specifies the use of the identifiable asset, and (2) the customer controls the use of the asset for that period. ASU-842 will have a significant impact on most companies.

One major concern is embedded leases. An embedded lease is a component within a contract that entails the use and control of an identified asset. Determining whether a contract contains an embedded lease is considered one of the most subjective steps in ASU-842.

Currently, an embedded lease is considered in many cases to be a rental agreement for an identified piece of equipment and an operator, based on a month-to-month term. Under ASU-842, if the rental of the equipment and the operator is expected to last 12 months or more, and the asset is identified and the entity has control over the use of the asset, the rental will need to be recorded as an embedded lease on the balance sheet. Embedded leases may become a substantial factor for contractors that have significant equipment rental agreements.

For example, a contractor enters into a contract to construct a building that will take two years to complete. The contractor also enters into a rental agreement for the crane that will be attached to the side of the building, and for the crane operator.

As the building is constructed, the crane will be used at the discretion of the contractor. Under the current standard, the monthly rental of the crane and the operator is charged to the project as a monthly rental expense.

Under the new standard, the contractor would be required 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 as an expense of the contract.

This represents debt on the contractor's financial statement that would not exist under the current ASU 840 standard.

ASU-842 will create new transparency on the contractor's financial statement, revealing the company's assets and long-term obligations, as compared to the current practice of recording these agreements as off-balance-sheet events.

Contractors should begin preparing for the new standard now by reviewing and analyzing their current leases, rental agreements, and contracts.

Being prepared for the potential impact of ASU 842, especially as it relates to identifying embedded leases, will allow companies to streamline a potentially difficult process that appears, finally, to be out of postponements. ■

Contractors should begin preparing for the new standard now.