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Now Is the Time for Contractors to Prepare for the New Lease Standard

By Ira Kantor, William A. Clark and Jr. | Thursday, March 14, 2019

Construction industry financial professionals have been cautiously awaiting the new lease standard (ASC 842) to take effect, and that time is finally here. The new lease standard, which eliminates off-balance sheet leases, is effective for public companies for reporting periods beginning on or after Dec. 15, 2018 (essentially 2019) and private companies for annual periods beginning on or after Dec. 15, 2019 (essentially 2020). ASC 842 will have an impact on all entities with leasing arrangements.

Many lenders and surety underwriters feel that there likely will not be a significant effect on construction contractor credit ratings, as they already factor into obligations related to off-balance sheet leases. However, there may be situations where certain contracts not previously considered leases under the old standards now will be considered leases, even though the contracts may not contain the word “lease.” Only time will tell how ASC 842 will impact each construction company’s financial statements, ratios and covenants.

To appreciate the changes under ASC 842, there are first some new terms to understand.

- Identified Asset: an asset that must be used to fulfill the terms of the contract.
- Right-of-Use Asset: the value of the identified asset at the reporting date.
- Lease Liability (or Obligation): the value of the liability at the reporting date.
- Operating Lease: a lease of more than 12 months, recorded on the balance sheet, that is not a financing lease.
- Financing Lease: currently called a “capital lease.”
- Short-Term Lease: generally, a lease with a term of 12 months or less, not be recorded on the balance sheet.
- Lease Term: non-cancellable lease period plus any renewal period that is “reasonably certain to be exercised and periods covered by a termination option reasonably certain not to be exercised.”

So, in order to get it right, what are construction industry financial professionals to do?

The first step is to determine whether a lease exists. ASC 842 defines a lease as “a contract, or part of a contract, that conveys the right to control the use of an identified asset throughout the period of use by possessing the right to:

1. obtain substantially all of the economic benefits from the use of such asset; and
2. direct the use of the identified asset."

If the supplier has a substantive right to substitute the asset throughout the period of use, it is not an identified asset and, therefore, there isn’t a lease. To have substantive substitution rights, the supplier must have the practical ability to substitute and the economic benefit from substituting.

If the determination is made that a lease exists, the lease must be evaluated and classified as either a financing lease or an operating lease. For financing and operating leases, an asset and a liability are recorded on the balance sheet. A lease is a financing lease if any of the following conditions are met (otherwise it is considered an operating lease):

- The lease transfers ownership of the asset to the lessee.
- There is a purchase option that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life.
- The present value of the lease payments and guaranteed residual equals or exceeds substantially all of the fair value of the underlying asset.
- The asset is of such a specialized nature that it is expected to have no alternative use to the lessor (new criteria under ASC 842).

For a financing lease, the right-of-use asset is recorded at the present value of the lease payments and is generally amortized on the straight-line basis over the shorter of the lease term or the useful life of the identified asset. The related lease liability is also initially equal to the present value of the lease payments and is adjusted using the interest method and reduced as payments are made on the lease.

For an operating lease, the right-of-use asset and lease liability are recorded at the present value of the lease payments. For an operating lease, a single lease cost is expensed on a straight-line basis (similar to current GAAP), and the lease liability is adjusted using the interest method. Amortization of the right-of-use asset is the difference between the straight-line lease expense and the interest expense related to the lease liability.

There are several other factors to consider when calculating the value of the right-of-use asset and the corresponding lease liability, such as the commencement date, the actual length of the lease including renewals, lease incentives, non-lease components, whether the payments are fixed or variable, the incremental borrowing rate and which initial direct costs should be included.

The bottom line is that construction companies need to make sure they have systems in place to properly implement the new lease accounting standard, and they should be discussing the potential changes to their financial statements with their lenders and surety underwriters as soon as possible.

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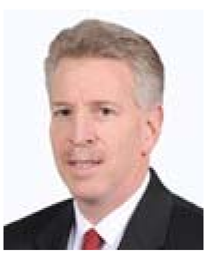

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