

What Architects, Engineers and Contractors Need to Know About the New Lease Accounting Standard - Part II

April 3, 2023



As a follow-up to our [Lease Accounting Standard Alert](#) on February 13, 2023, this alert goes into more detail regarding the new lease accounting standards and what your company needs to know in order to comply.

In 2016, the Financial Accounting Standards Board (FASB) finalized the new lease accounting standard (ASC 842) for private companies. After many years of pushback and delays, the time for implementation is here. ASC 842 must be adopted by companies with fiscal years beginning after December 15, 2021 and for interim period financial statements beginning after December 15, 2022.

Under previous standards, leases were broken down into two categories - capital leases and operating leases. Capital lease obligations (for example, leases where the lessee took ownership of the asset at the conclusion of the lease term) were recorded on the balance sheet as a liability and the corresponding item being leased was recorded as an asset and depreciated over its useful life. Operating leases (any non-capital leases, the most common being leases for real estate, office space, yard

space, etc.) were not recorded on the balance sheet at all. Rather, the lease commitment was disclosed in the footnotes of the financial statements.

Under ASC 842, this distinction is largely done away with in presentation. All leases greater than twelve months are reported on the balance sheet as a lease liability with a corresponding right-of-use asset, whether the lease is for real estate, field equipment, office equipment, furniture, etc. Also included are related party leases (for example, a company leases real estate which is owned by a stockholder/member). If you are a lessor, the standard has minimal impact on you.

While conceptually this may sound simple, there are several items to be considered in determining how a lease should be accounted for. The following are a few key procedures companies will have to perform to properly implement ASC 842:

- Identify and gather all of the company's leases.
- Determine if each lease is an operating lease or a finance lease (formerly capital lease).
- Evaluate the impact on related party leases from ASC 842 and related leasehold improvements.
- Review contracts for embedded leases. For example, the company hires a subcontractor who is required to provide identified equipment onsite which the company can direct the usage of for more than 12 months.
- Identify non-lease components that could be included in lease arrangements such as operating expenses and common area maintenance.
- Determine the discount rate to use for computation of the lease liability and right-of-use asset.
- Record the appropriate entries on the company's books as the expense is presented differently for an operating lease versus a financing lease.
- Properly disclose the lease transactions in the footnotes to the financial statements. These disclosures will be more extensive than the previous lease commitment footnote disclosures.

Recording these leases on the balance sheet will impact the company's covenants. A couple of examples:

- The company's current ratio and working capital will decrease as a portion

of the lease liability will be shown as a current liability and the right-of-use asset is a non-current asset.

- The company's leverage ratio (debt to equity) will increase as the total debt on the balance sheet will increase while equity remains the same.
- The company's EBITDA would improve should the company determine it has financing leases (as the expenses under these leases are shown as part of interest expense and amortization expense).

A/E/C companies need to understand how implementing ASC 842 will affect covenant compliance with their existing loan agreements and how to account for this impact when renewing or entering into new loan agreements. Contractors will need to understand how sureties will evaluate the impact of ASC 842 in determining bonding capacity it will provide the contractor. As always, communication is key. These matters should be addressed now so that there are no unpleasant surprises later when 2022 financial reports are provided to the banks and sureties.

The transition to ASC 842 will take considerable time and planning to implement. Understanding the rules and requirements for the transition can save you valuable time and reduce compliance risk.

For more information regarding ASC 842 and how your company can implement it, please contact [Steven Linden](#), [Phillip Ross](#), [Joseph Zeller](#), or your Anchin Relationship Partner.