

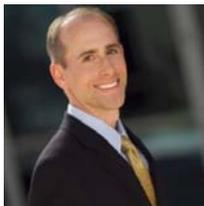


Construction Financial Management Association - Valley of the Sun Chapter
ASC 842, Leases – Adoption Tips & Strategies

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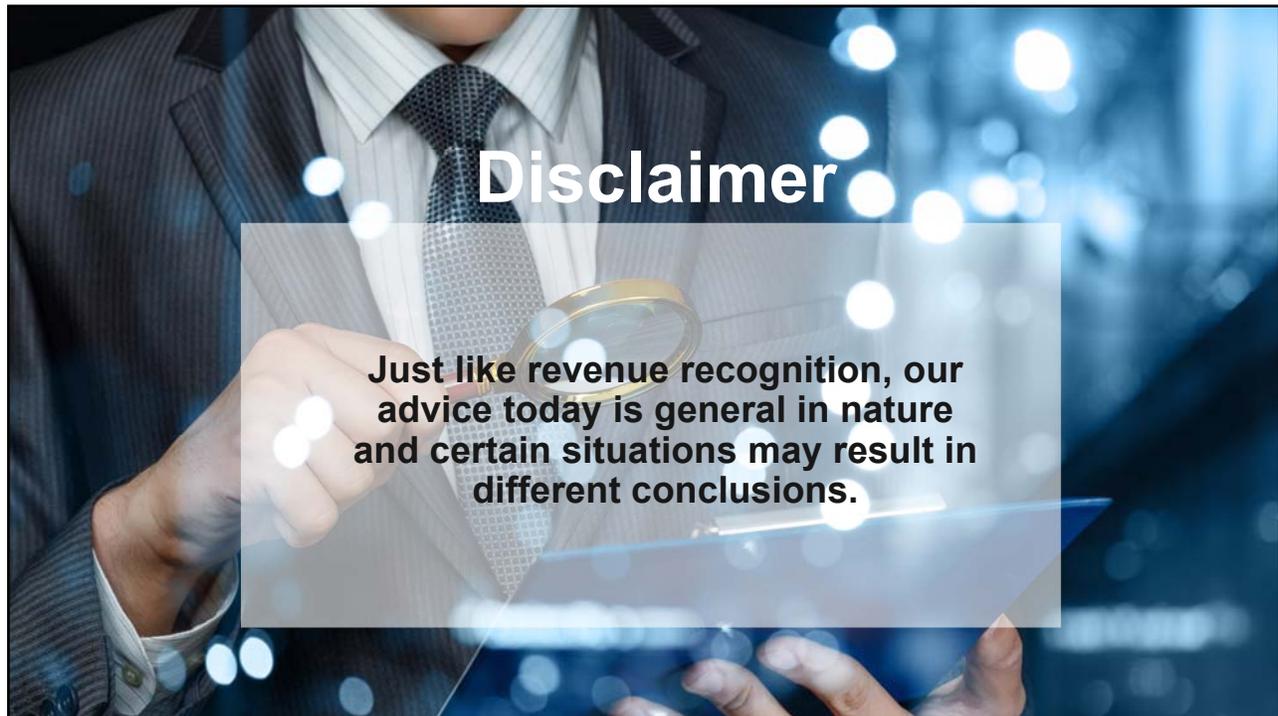
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Learning Objectives



-  Learn practical application of the new lease accounting model from lessee's perspective, including key elements that will affect identification, recognition and measurement of lease arrangements
-  Understand the financial statement presentation and disclosures required of lessees under the new accounting model
-  Recognize transition matters that may affect the business (including potential impact on banking and bonding requirements) and the steps that should be taken now to prepare for implementation

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POLL – Who is here?



-  I'm responsible for helping my Company adopt
(Controllers, CFOs)
-  I'm responsible for helping my clients adopt
(External CPAs)
-  I'm a financial statement user
(Surety, Bonding, Banks)
-  I'm just here for the good company!
(Other)

Why is this helpful for you?

-  Controllers and CFOs
-  External CPAs
-  Surety, Bonding, Banks
-  Just Here for the Good Company



POLL – Where are you at with your adoption process?



- a.** Still traumatized from revenue recognition and haven't started
- b.** I've sat through a few webinars but haven't dug in yet
- c.** I've got a plan and just need to execute it
- d.** Done! Again...just here for the good company

Déjà vu?

- Impact of implementing Topic 606
 - Documentation vs. qualitative
- Impact of implementing Topic 842
 - Documentation
 - Qualitative



Step One – Take Inventory



What is a lease?

The contract is or contains a lease if it conveys the **right to control the use** of identified property, plant or equipment (i.e. **an identified asset**) for a **period of time** in exchange for consideration.

Short-term leases can be excluded

Lease term has to be 12 months or less, and lease cannot contain a bargain purchase option that the lessee is reasonably certain to exercise.

Be careful with related party leases.

Step One – Take Inventory (continued)



What is included within the scope of 842?

Existing capital leases
 Existing operating leases
 Caution for embedded leases
 - *Tower crane example used in the standard for subcontract services*

What is not included within the scope of 842?

Leases of intangible assets
 Leases to explore for or use non-regenerative resources
 Leases of biological assets
 Leases of inventory
 Leases of assets under construction

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Step Two – Create a Task Force and a Timeline



Task Force



Right level of skills and expertise

Timeline



Work backwards from implementation date

- Consider budgeting process
- Give yourself grace for delays

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Step Three – Determine your Analysis Approach



1. Self-perform
 - Excel
 - CPA Firm may have a tool to assist with calculations
2. Software options for automation
3. Adoption consulting

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Step Four – Execute!



1. Separate your lease and non-lease components
 - Affixed to the asset and/or not separable
2. Determine if you have a finance or operating lease
 - Now five criteria for a finance lease
3. Mock up your balance sheet with 842 adopted

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Common Pitfalls

1. Discount rate options
2. Lease term

Key Considerations



Lease commencement vs. inception

- Under 840, classification and initial measurement were at lease inception, recognition was at commencement
- Under 842, classification, initial measurement and recognition are all at commencement, meaning when the asset is available for use.
- Could impact your conclusions if there is a significant period of time between inception and commencement. Could also impact which discount rate you use and result in different lease classifications.

Key Considerations (Continued)



Covenant Considerations

Do you need to talk to your bank about grandfather provisions or anticipated waivers?

- **Debt vs. Liability**
- **Working Capital**



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Practical Expedients

- a. First bundle must be elected as a package and applied to leases**
 - Do not need to reassess whether expired/existing contracts are or contain leases
 - Do not need to reassess the lease classification for any expired/existing leases
 - Capital = financing, discount rate is your implicit rate
 - Operating = operating
- b. Election not to separate lease and non-lease components in a contract**
- c. Election to use a risk-free rate – must apply to all leases unless the implicit rate is readily known**
- d. Election to apply the hindsight approach when:**
 - Determining the lease term
 - Assessing impairment of the ROU assets



Example Scenario

- 36-month lease term
- Lease payments made in arrears (\$10k at end of year 1, \$11k at end of year 2, and \$12,500 at end of year 3)
- Lessee's discount rate is 5.51%
- Total lease payments are \$33,500 (PV is \$30,000)

Finance Lease

36-month lease term
 Lease payments made in arrears (\$10k at end of year 1, \$11k at end of year 2, and \$12,500 at end of year 3)
 Lessee's discount rate is 5.51%
 Total lease payments are \$33,500 (PV is \$30,000)

	ROU Asset	Amort Expense	Interest Expense	Principal Payment	Annual Payment	Lease Liability
Commencement	\$ 30,000					\$ 30,000
Year 1	20,000	\$ 10,000	\$ 1,654	\$ 8,346	\$ 10,000	21,654
Year 2	10,000	10,000	1,193	9,807	11,000	11,847
Year 3	-	10,000	653	11,847	12,500	-
		\$ 30,000	\$ 3,500	\$ 30,000	\$ 33,500	

Operating Lease

36-month lease term
 Lease payments made in arrears (\$10k at end of year 1, \$11k at end of year 2, and \$12,500 at end of year 3)
 Lessee's discount rate is 5.51%
 Total lease payments are \$33,500 (PV is \$30,000)

	ROU Asset	Amort Component	Interest Component	Lease Expense	Annual Payment	Lease Liability
Commencement	\$ 30,000					\$ 30,000
Year 1	20,488	\$ 9,512	\$ 1,654	\$ 11,166	\$ 10,000	21,654
Year 2	10,514	9,974	1,193	11,167	11,000	11,847
Year 3	-	10,514	653	11,167	12,500	-
		\$ 30,000	\$ 3,500	\$ 30,000	\$ 33,500	

Journal Entries - Commencement



Finance Lease			Operating Lease		
ROU asset	\$30,000		ROU asset	\$30,000	
Lease liability		\$30,000	Lease liability		\$30,000

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Journal Entries – Year 1



Finance Lease			Operating Lease		
Lease liability	\$10,000		Lease expense	\$11,166	
Cash		\$10,000	Lease liability	\$ 8,346	
Interest expense	\$ 1,654		ROU asset		\$ 9,512
Lease liability		\$ 1,654	Cash		\$10,000
Amortization expense	\$10,000				
ROU asset		\$10,000			

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Journal Entries – Year 2



Finance Lease			Operating Lease		
Lease liability	\$11,000		Lease expense	\$11,167	
Cash		\$11,000	Lease liability	\$ 9,807	
Interest expense	\$ 1,193		ROU asset		\$ 9,974
Lease liability		\$ 1,193	Cash		\$11,000
Amortization expense	\$10,000				
ROU asset		\$10,000			

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Journal Entries – Year 3



Finance Lease			Operating Lease		
Lease liability	\$12,500		Lease expense	\$11,167	
Cash		\$12,500	Lease liability	\$11,847	
Interest expense	\$ 653		ROU asset		\$10,514
Lease liability		\$ 653	Cash		\$12,500
Amortization expense	\$10,000				
ROU asset		\$10,000			

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Disclosures



Qualitative

- Nature of leases
- Residual value guarantees
- Significant assumptions and judgments
- Policies on separating lease and non-lease components, short-term leases and related parties

Quantitative

- Lease expense for the period (amortization and interest)
- Short-term lease expense, variable cost, and sublease income
- Supplemental cash and non-cash information
- Weighted average remaining lease term and discount rate

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Model Implementation Standards Before & After

Before ASC 842

HOOSIER CONSTRUCTION, INC.	ASSETS
Current Assets	
Cash	\$ 50,000
Contracts receivable	100,000
Contract assets	40,000
Inventory	<u>20,000</u>
Total Current Assets	210,000
Property and Equipment, net	<u>30,000</u>
Total Assets	<u>\$ 240,000</u>

After ASC 842

HOOSIER CONSTRUCTION, INC.	ASSETS
Current Assets	
Cash	\$ 50,000
Contracts receivable	100,000
Contract assets	40,000
Inventory	<u>20,000</u>
Total Current Assets	210,000
Property and Equipment, net (including finance lease right-of-use assets, net of \$20,000)	<u>30,000</u>
Operating Lease Right-of-Use Assets	<u>\$ 20,488</u>
Total Assets	<u>\$ 260,488</u>

Before ASC 842

HOOSIER CONSTRUCTION, INC.	LIABILITIES
Current Liabilities	
Accounts payable	\$ 40,000
Note payable, \$200,000 LOC	20,000
Current portion of LTD	10,000
Contract liabilities	<u>60,000</u>
Total Current Liabilities	130,000
Long-Term Debt, less current portion	<u>30,000</u>
Total Liabilities	160,000
Stockholders' Equity	<u>80,000</u>
Total Liabilities and Stockholders' Equity	\$ <u>240,000</u>

After ASC 842

HOOSIER CONSTRUCTION, INC.	LIABILITIES
Current Liabilities	
Accounts payable	\$ 40,000
Note payable, \$200,000 LOC	20,000
Current portion of LTD	10,000
Current portion of operating lease ROU liability	9,807
Contract liabilities	<u>60,000</u>
Total Current Liabilities	139,807
Long-Term Debt, less current portion	30,000
Operating lease ROU liability, less current portion	<u>11,847</u>
Total Liabilities	181,654
Stockholders' Equity	<u>78,834</u>
Total Liabilities and Stockholders' Equity	\$ <u>260,488</u>

Key Contractor Metrics



Before ASC 842

- Working Capital - \$80,000
- Total Liabilities to Equity – 2.0 : 1.0

After ASC 842

- Working Capital - \$70,193
- Total Liabilities to Equity – 2.3 : 1.0

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Internal Control Considerations



Document!

- Process for adoption – key controls (i.e. skills and expertise, completeness of analysis, etc.)
- Procedures for determining classification, measurement and recognition of right-of-use assets and liabilities
 - Possible policy elections acceptable for insignificant leases
- Subsequent accounting and re-evaluation
 - Consider subsequent modifications and if they will have a significant impact



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