



## Presenters



### **Jared Asay, CPA, CCIFP, CEPA**

Financial Partner

**Conover Asay CPAs, PLLC**

Tel: 480-500-6333

[jasay@conoverasay.com](mailto:jasay@conoverasay.com)



### **Lindsey Benson, CPA, CCIFP**

Audit Senior Manager

**CBIZ & Mayer Hoffman McCann, PC**

Tel: 602-308-6661

[lindsey.benson@cbiz.com](mailto:lindsey.benson@cbiz.com)

## 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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## Disclaimer





**Just like revenue recognition, our advice today is general in nature and certain situations may result in different conclusions.**

## 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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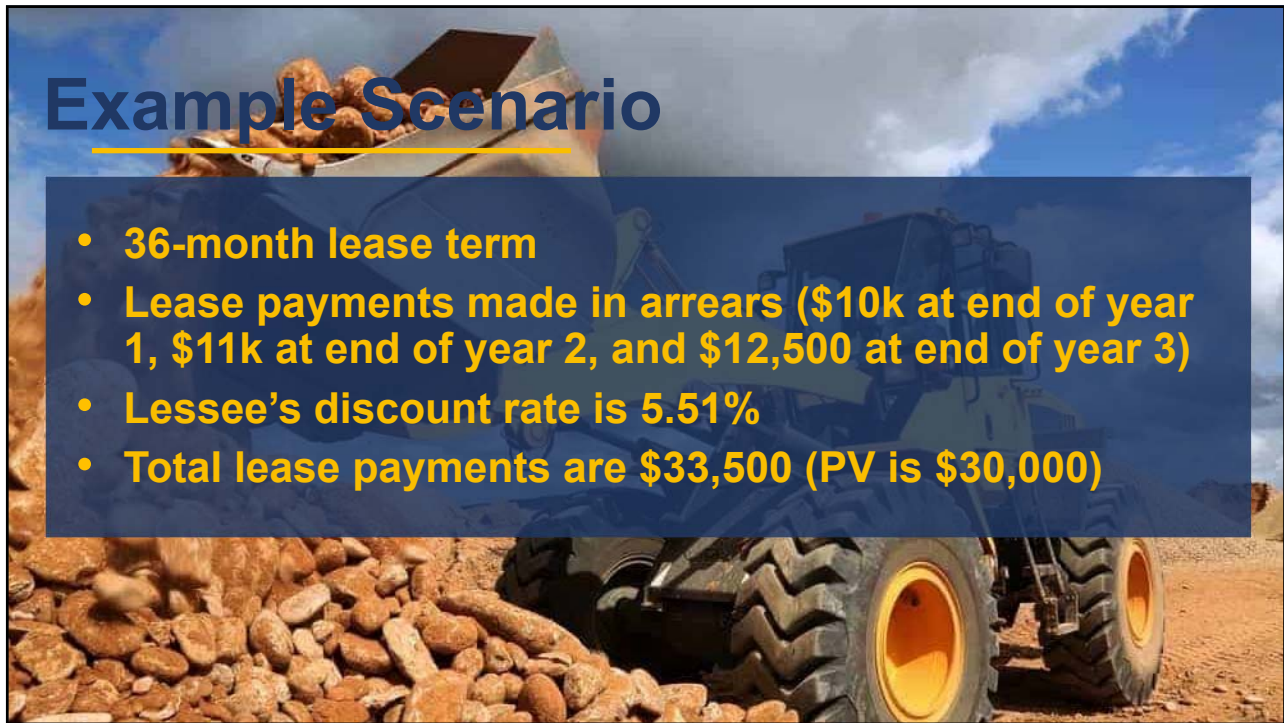
## Practical Expedients

- 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

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

### Operating Lease

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

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## Journal Entries – Year 1



### Finance Lease

Lease liability	\$10,000	
Cash		\$10,000
Interest expense	\$ 1,654	
Lease liability		\$ 1,654
Amortization expense	\$10,000	
ROU asset		\$10,000

### Operating Lease

Lease expense	\$11,166	
Lease liability	\$ 8,346	
ROU asset		\$ 9,512
Cash		\$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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cbiz.com/phx

