INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

# CARPE DIEM: NOW'S THE TIME FOR GOVERNMENT CONTRACTORS TO PREPARE FOR NEW LEASE ACCOUNTING

**By Amy Thorn**

## BACKGROUND

In February 2016, the Financial Accounting Standards Board (FASB) issued its highly-anticipated leasing standard in ASU 2016-02, *Leases (Topic 842)*, for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use (ROU) assets and related lease liabilities on the balance sheet for all leases, except for short-term leases (12 months or less) for which the recognition exemption is elected.

The objective of updating the leases guidance was to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

The new guidance is intended to address stakeholder concerns that the previous leases guidance did not result in a faithful representation of leasing transactions—specifically that the rights and obligations associated with operating leases were not recognized on the balance sheet.

## IMPLEMENTATION DEADLINES DRAW NEARER

ASU No. 2016-02 takes effect in 2019 for public entities and in 2020 for all other entities. Given the magnitude of the impact this standard will have on most entity's balance sheets, it is important to obtain an understanding now, particularly if you are or will be in the process of negotiating new long-term leases between now and the effective date.

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## IMPACT TO GOVERNMENT CONTRACTORS

Generally, leases that are presently classified as operating leases will remain operating leases under the new guidance. Similarly, leases that are presently classified as capital leases will be classified as finance leases under the new guidance. Rent expense recorded under operating leases, and amortization expense associated with the ROU asset under finance leases, will be allowable for purposes of calculating indirect rates. The interest expense portion under finance leases will be unallowable, in accordance with Federal Acquisition Regulation.

## PRACTICAL POINTS FOR IMPLEMENTATION

We expect that lenders, investors, and other users of the financial statements will have a solid understanding of the guidance well in advance of the effective date. Companies are wise, however, to ensure they are educating executive management, audit committees and boards of directors on the upcoming standard, and the impact it will have on their financial statements. They should also be prepared to discuss financial and other restrictive covenants with lenders and investors well in advance of the effective date.

The scope of the new standard is largely consistent with prior guidance, and limits the definition of a lease to physical assets. With the implementation of ASC 842, it is critical that leases are properly identified, as operating leases will now have a material impact on the balance sheet for most entities. Service agreements that include a lease of related equipment, such as cloud computing arrangements that include leasing related hardware, will require careful analysis.

The lease liability is calculated as the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement. The discount rate should be the implicit rate in the lease, if that rate is readily determinable. If not, the lease should use its incremental borrowing rate, which is defined as the rate that the lessee would have incurred to borrow the funds necessary to purchase the leased asset over a term similar to the lease term. It should be noted that the standard includes an optional practical expedient, whereby non-public entities may use a risk-free rate, determined using a period comparable to that of the lease term, as an accounting policy applied to all leases.

The federal income tax law governing the treatment of leases has not changed. However, make sure you understand the impact of ASC 842 on your financial statements, and discuss the potential tax implications with your advisors. Implementation of the new standard may result in new deferred tax assets or liabilities or new book to tax differences in the entity's income tax provision.

## IMPLEMENTATION METHODS

ASU 2016-02 initially provided a single transition method with which to adopt the new leases guidance: the modified retrospective transition method. On July 30, 2018, the FASB issued ASU 2018-11, *Leases (Topic 842) – Targeted Improvements*, which provides entities with an additional (and optional) transition method with which to adopt the new lease guidance. Under this new transition method, entities initially apply the new guidance at the adoption date (rather than at the beginning of the earliest period presented) and recognize a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption (for example, Jan. 1, 2019 for a calendar year-end public entity). This means that the comparative periods presented in the financial statements will remain under the legacy leases guidance. The FASB provided this additional transition method to reduce costs and complexity for preparers in implementing the new standard. However, even with this welcomed relief, entities should not delay their implementation efforts considering the numerous implementation activities that must take place for a successful and timely adoption.

The standard also provides for certain other optional practical expedients that will make implementation of the new standard more practical. One such practical expedient, and one that will likely be widely used in practice, is that an entity has the option to record the lease on the balance sheet, but will not be required to reconsider the classification of the lease before the effective date. That is, leases previously classified as operating under the old guidance will be accounted for as operating leases, and leases that were previously classified as capital leases will be classified as finance leases. Additionally, the entity is not required to reconsider whether existing contracts contain a lease.

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## PRESENTATION AND DISCLOSURE

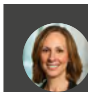
ROU assets resulting from finance leases must be presented separately from ROU assets resulting from operating leases and other assets. The same applies to presentation of lease liabilities. Additionally, current and long term portions of assets and liabilities must be properly presented on the balance sheet.

The FASB stated in paragraph 264 of the ASU in the *Basis for Conclusions* that it is appropriate to separate the assets and liabilities resulting from operating and finance leases due to the difference in the nature of the transactions. A finance lease is debt-like while an operating lease is not. Accordingly, combining these assets and liabilities on the balance sheet could be misleading.

The new standard requires substantial disclosures related to lessees. Disclosures required include, but are not limited to, the following:

- General description of the lease
- Terms related to any variable lease payments and options to extend or terminate the lease (both those that are included in the measurement of the ROU asset and lease liabilities and those that are not)
- Terms of purchase options
- The allocation of consideration between lease and non-lease components, and the determination of the discount rate for the lease
- Finance lease costs, with interest on the lease liability and the amortization of the ROU assets separately reported. Operating lease costs are also separately reported.

For more information on the lease accounting standard, read BDO's Assurance newsletter on FASB Topic 842 **here**. You can reference all FASB Accounting Standard Updates, including ASU 2016-02, and its amendments (ASU 2018-10 and 2018-11) **here**.



*Amy Thorn is a partner in BDO's Assurance practice and has extensive experience in audit and consulting engagements for government contractors. She may be reached at athorn@bdo.com.*

## CONTACT

**ED AMOROSSO**
Managing Partner
757-640-7295 / eamorosso@bdo.com

**ERIC FAHR**
Transaction Advisory Services Partner
703-770-6328 / efahr@bdo.com

**AARON RADDOCK**
Managing Director, Industry Specialty Services – Government Contracts
703-336-1693 / araddock@bdo.com

**STEPHEN RITCHEY**
Audit Partner
703-770-6346 / sritchey@bdo.com

**DEREK SHAW**
Managing Director
703-336-1501 / dshaw@bdo.com

**ERIC JIA-SOBOTA**
National Leader, Government Contracts and Grants Advisory Services
703-770-6395 / esobota@bdo.com

**AMY THORN**
Assurance Partner
703-770-6318 / athorn@bdo.com

**ANDREA WILSON**
RAS Partner
703-752-2784 / aewilson@bdo.com

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