

Key Considerations for Leases Under the New Leasing Standard in Construction



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In 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02 changing the way companies account for leases. In 2020, the FASB issued ASU 2020-05 that delayed the effective date of the new leasing standard. As a result of this delay, most private companies will be implementing the new leasing standard starting with calendar 2022 year ends. For many private companies, especially those within the construction industry, the new leasing standard will require significant analysis of operations and transactions to identify the agreements that will be classified as leases under the new standard. Of particular interest is the impact that the standard has on related party leases.

It has become normal within the construction industry for the buildings, and even the equipment, used by the operating construction company to be held by a separate, related entity in order to mitigate risk and provide for certain tax strategies. The use of these related real estate and equipment companies will likely result in significant lease transactions between them and the construction company being evaluated under the new leasing standard. The recognition of lease liabilities and right-of-use assets on the balance sheet of the construction company, as a result of the new leasing standard, could have a significant financial impact, and may impact working capital ratios thereby impacting debt covenants and bonding capacity.

Key areas which need to be considered when performing the evaluation of leases under the new leasing standard include the following:

- 1. Use of written lease agreements** – All lease agreements, including those with related parties, should be formalized with a written agreement between the lessor and lessee. This will make determinations under the new leasing standard easier to perform.
- 2. Lease terms** – The new leasing standard requires that a related-party lease be classified and accounted for based on its legally enforceable terms and conditions. In other words, the classification and accounting for a lease with a related-party lessor should be the same as what the classification and accounting would have been if that lease were with an unrelated lessor.

There are two critical areas that should be considered when it comes to the length of all leases, but especially a related party lease:

- a. Understanding the legally enforceable terms and conditions** – A lease will be recognized under the new leasing standard based upon its legally enforceable terms and conditions. The lessee is required to consider whether there are any implicit legally enforceable terms and conditions in addition to the terms and conditions in the written agreement.

For example, if the construction company leases a facility to perform pre-fabrication work and the lease has a term of one year with no option to renew, but the construction company has incurred significant costs related to leasehold improvements that will retain significant value over their useful life of 20 years, consideration will need to be given to whether there are implicit legally enforceable terms and conditions that would cause the lease term to be evaluated as 20 years instead of one year.

Another example would be if the construction company leases construction equipment on a month-to-month basis from a related party and that equipment is going to be used throughout the period of construction of a project that is expected to take two years to complete, consideration should be given to whether there are implicit legally enforceable terms and conditions that would cause the lease term to be evaluated as two years instead of one month.

b. Impact on capitalized leasehold/tenant improvements – Leasehold/tenant improvements should be depreciated over the shorter of the useful life of the asset or the term of the lease.

For example, using the example in 2(a) above, if the construction company determines that the lease for the pre-fabrication workshop is truly a one year lease, then the leasehold improvements related to the workshop would have a maximum depreciable life of one year (i.e. the lease term of one year is shorter than the useful life of the assets). The treatment of the lease as a one year lease would likely result in significant depreciation charges/write downs of the leasehold improvements.

This treatment could also flow through to any leasehold or tenant improvements within the lessor entity in any GAAP financial statements they issue. For example, if the lessor entity has capitalized improvements made on behalf of the construction company and those improvements are specific to the construction company and would likely be unwanted/useless to any alternative lessee (for example signage), there could be the need to recognize impairment charges on those improvements to write them off over the one year term of the lease.

3. Lease payments – Companies will need to analyze lease payments within the agreements to determine if they are fixed, in-substance fixed, variable based upon a rate or index or variable based upon other than a rate or index. This analysis is critical in order to correctly identify the lease payments that are used in classifying the lease and measuring the related lease liability and right-of-use (ROU) asset.

a. Fixed lease payments – Fixed lease payments are included in the calculation of the ROU asset and lease liability. Payments that vary solely based on the passage of time (e.g. escalating rents) are not considered variable lease payments, and would be included in the calculation of the ROU asset and lease liability.

Example: Lessee is a private company with a calendar year end. Lessee enters into a lease with Lessor on January 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. Lessee must pay Lessor \$100,000 on January 1, 20X7. The lease payments on January 1, 20X8 and 20X9 are increased by 2% each year.

The amount of the lease payments that should be included in classifying the lease and measuring the related lease liability and ROU asset are \$100,000 for year 1, \$102,000 (i.e. \$100,000 increased by 2%) for year 2 and \$104,040 (i.e. \$102,000 increased by a further 2%) for year 3.

b. In-substance fixed payments – A lease agreement may describe a payment as a variable payment, but upon closer look it is apparent there is an amount that must be paid (e.g. a minimum amount that cannot be avoided) or there is an amount that will be paid because the variability lacks economic substance. These types of variable lease payments are in-substance fixed payments and are treated as fixed payments when determining lease payments for the calculation of the lease liability and ROU asset.

Example: A lease requires a lessee to pay rent equal to 1% of its sales, subject to a minimum sales figure of \$5 million. The in-substance fixed payment is the minimum amount the lessee will be required to pay of \$50,000 (\$5 million × 1%), which should be included in lease payments on the commencement date to calculate the ROU asset and lease liability. Any potential payments above the minimum amount are

based on the lessee's sales and should be accounted for as variable lease payments based on other than an index or rate (see below). Another way that this payment term could be worded in the lease agreement, but still result in the same outcome, would be if the lessee was required to make a payment of \$50,000 or 1% of its sales, whichever is greater. In this situation, there is an in-substance fixed payment of \$50,000 that will be required of the lessee.

c. Variable based upon a rate or index – Variable lease payments that depend on an index or rate are initially measured and included in lease payments by reference to the index or rate at the commencement date of the lease. Any additional lease costs arising from subsequent changes to the index or rate are recognized in the period those costs are incurred (i.e. similar to variable lease payments based on other than an index or rate as discussed below). Common examples of indexes and rates on which variable lease payments are based include: the Consumer price index (CPI), the prime or LIBOR interest rate, interest rates on direct Treasury obligations of the U.S. government (with or without a spread) and market rental rates.

Example 1: Lessee is a private company with a calendar year end. Lessee enters into a lease with Lessor on January 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. Lessee must pay Lessor \$100,000 on January 1, 20X7. The lease payments on January 1, 20X8 and 20X9 are \$100,000 adjusted for the cumulative increase in the Consumer Price Index (CPI) since January 1, 20X7. No refunds are provided if the CPI decreases.

There is a fixed lease payment of \$100,000 per year paid in arrears. The amount of the variable lease payment that should be included in the lease payments used in classifying the lease and measuring the related lease liability and ROU asset should be determined initially by reference to the CPI at the commencement date, and assuming that it will not change over the term of the lease. Given that the variable lease payment is based on the increase in the CPI after January 1, 20X7, the variable lease payment on that date is zero. As such, the amount of lease payments used in the classification and measurement of the lease on January 1, 20X6 is \$300,000 (annual payments of \$100,000 over the lease term of three years).

Example 2: Lessee is a private company with a calendar year end. Lessee enters into a lease with Lessor on January 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. Lessee must pay Lessor \$100,000 on January 1, 20X7. The lease payments on January 1, 20X8 and 20X9 are \$100,000 increased each year by the 1-month LIBOR rate. At the commencement date of the lease the 1-month LIBOR rate is 2%.

The amount of the variable lease payment that should be included in the lease payments used in classifying the lease and measuring the related lease liability and ROU asset should be determined by reference to the 1-month LIBOR rate at the commencement date of the lease (and again assuming it will not change over the term of the lease). As the rate on January 1, 20X6 was 2%, then the lease payment for year 1 would be \$100,000, for year 2 would be estimated as \$102,000 (i.e. \$100,000 increased by 2%) and for year 3 would be estimated as \$104,040 (i.e. \$102,000 increased by a further 2%) for the classification and measurement of the lease on January 1, 20X6. Any difference in the lease costs arising from differences between the actual LIBOR rate and 2% (the LIBOR rate at lease commencement) in years 2 and 3 are recognized in the period those costs are incurred (i.e. similar to variable lease payments based on other than an index or rate as discussed below).

d. Variable based upon other than a rate or index – Variable lease payments that vary after the commencement date for reasons other than an index or rate are not included in the lease payments used for classification or measurement purposes. When the only payments in a lease are variable based on other than an index or rate, there are no lease payments on which to base the recognition and measurement of a lease liability and ROU asset. Therefore, there would be no recognition of a lease liability or ROU asset.

Example: Lessee is a private company with a calendar year end and has no interim financial reporting requirements. Lessee enters into a lease for the exclusive right to use a specifically identified production

printer. Lessor does not have substantive substitution rights related to the production printer. The lease is entered into on July 1, 20X6, which is also the lease's commencement date. The noncancellable term of the lease is three years. There are no purchase, renewal or termination options. On a monthly basis, Lessee must pay Lessor \$0.10 per page printed by the production printer in the previous month. For example, in August 20X6, Lessee pays Lessor \$0.10 per page printed by the production printer in July 20X6.

The only payments required under the lease are variable lease payments based on other than an index or rate. As a result, there are no lease payments that give rise to recognition of a lease liability or ROU asset. The variable lease payments are included in lease costs as the printer is used. For example, if Lessee used the production printer to print 2,720 pages in July 20X6, it should recognize lease expense of \$272 for that month. This same example would apply for construction equipment being leased based upon an hourly usage rate.

Much like the previous changes to revenue recognition, the new leasing standard can be a complex accounting standard to navigate.

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Simon Keemer, CPA, CGMA, ACA

Assurance Director

skeemer@deandorton.com • 502.566.1036