INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

ASC TOPIC 842 AND ITS IMPACT ON GOVERNMENT CONTRACTING

Government contractors were breathing a collective sigh of relief when the Financial Accounting Standards Board (FASB) pushed back the deadline for private companies and nonprofits to comply with new lease accounting rules in April 2020. Accounting Standards Codification (ASC) Topic 842, also known as Accounting Standards Update (ASU) 2016-02, *Leases* is now applicable for the fiscal year and interim periods beginning after Dec. 15, 2021. Topic 842 applies to both lessees and lessors, and it brings significant changes to balance sheets. Just because companies have more time, doesn't mean they can afford to let more pass before acting on implementation. Now is the time for government contractors to familiarize themselves with the new standard, mitigate the impact of resource constraints on implementation, navigate allowability of costs and otherwise move past hurdles to prepare for compliance.

BACKGROUND

In February 2016, the FASB issued ASU 2016-02, which superseded the lease guidance under Leases (Topic 840) and made several changes, such as requiring an entity to recognize a right-of-use (ROU) asset and corresponding lease obligation on the balance sheet, classified as financing or operating, as appropriate. 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.

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.

See additional guidance from the BDO team as it relates to the full standard and other key items to consider with our lease accounting guide.

IMPACT ON GOVERNMENT CONTRACTING

Since its introduction, the new standard has raised concerns among government contractors. One major concern is the allowability of rental expense under FAR Part 31. Contractors have expressed worry that the new standard could impact rental expense calculation and the allowability of costs. Fortunately for government contractors, under ASU 2016-02, 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 FAR, consistent with prior accounting for capital leases.

The new standard requires virtually all leases to be recognized on the balance sheet by lessees, which is a significant change. Under Topic 842, a lessee will recognize ROU assets and related lease liabilities on the balance sheet for virtually all leases regardless of classification. This change could impact financial covenants, thus causing discussions with lenders related to the impact to bear even greater importance in the upcoming months. If you have not already done so, be prepared to discuss financial and other restrictive covenants with lenders and investors well in advance of year end reporting.

As companies face internal resource constraints and accounting departments are already stretched, implementation of ASU 2016-02 is another key item to budget and plan for. There are various practical expedients available to simplify the process, and government contractors are encouraged to explore these options prior to implementation.

Lastly, 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.

The objective of the disclosure requirements is to enable users of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. Now is the time to work through the required financial statement disclosure impacts.

CONCLUSION

Topic 842's impending implementation brings new disclosure requirements for government contractors. Government contractors can use this time to determine how the new standard will impact operations and adopt a reporting system that aligns with its requirements. Proactive adherence to Topic 842 will help government contractors adjust to the new standard and better equip them to navigate emerging legislation.

Reference the new accounting standards with mandatory effective dates in the first quarter of 2022 for public entities, as well as new standards that take effect in annual 2021 financial statements for nonpublic entities.

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