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Financial Reporting Under ASU 842

By Robert Mercado | Wednesday, July 6, 2022

For many years, there has been talk of a new lease accounting standard for financial reporting known as ASU 842. Due to the pandemic, ASU 842 was deferred from the previous implementation date until entities with fiscal year ends after December 15, 2022. Many were hopeful that ASU 842 would be deferred once again. Unfortunately, those hopes of an additional deferral have faded away. Entities are now expecting that the implementation of this new standard will be required for all entities once they reach their year-end subsequent to December 15, 2022. This new lease standard is expected to have a significant impact on how entities report certain types of leases on their financial statements. This change could have a detrimental impact on the way outside parties view a contractor's financial statement. The interesting thing is that economically nothing has changed for a contractor, the only thing that has changed is how certain leases will be reported.

OPERATING VS. FINANCING (CAPITAL) LEASES

In order for a lease to be covered under the new lease standard the lease must be for a period of 12 months or greater otherwise, it would be expensed on a monthly basis to the entities income statement. There are two types of leases under ASU 842, operating and financing. Financing leases are essentially capital leases under the old lease standard. It is important to distinguish the type of lease that an entity enters into in order to properly report the activity on the entity's financial statements. If a lease meets any of the following criteria, it will be treated as a finance lease:

- Transfers ownership of the underlying asset.
- Grants the option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- Major part of the remaining economic life, essentially excluding the last 25% of the economic life.
- Present value of the lease payments and any additional residual value guaranteed by the lessee equals or exceeds 90% or more of the fair value of the underlying asset.
- The underlying asset is specialized in nature, meaning there is no alternative use to the lessor at the end of the lease.

If the lease does not meet any of the above criteria it would be considered an operating lease.

FINANCIAL STATEMENT REPORTING

Under the current lease standard, a leased asset that meets the capitalization requirements would be considered a capital lease and included in the long-term asset known as property and equipment on the entities balance sheet. In addition, the corresponding liability associated with the future payments owed on the lease would be reported as debt on the entity's balance sheet. This asset would then be amortized to the income statement over the estimated useful life of the asset or the lease term, whichever is shorter. Operating leases on the other hand are currently not reported as a long-term asset on the entity's balance sheet, they are expensed to the entity's income statement on a monthly basis to a rent or lease expense account.

The liability for future minimum lease payments associated with the operating leases are only disclosed in the notes to the financial statements. They are not currently reported as debt on the entity's balance sheet. For capital leases, the name has been changed to finance leases. In addition, the assets associated with the capital leases would be separately reported as a long-term asset called right-to-use financing leased asset on the entity's balance sheet. The major change under the new standard is how operating assets are reported. Under the new standard, the leased operating asset will be capitalized on the entity's balance sheet as a right-to-use operating leased asset. In addition, the liability associated with the operating leased assets would be reported as debt on the balance sheet, at a discounted present value, consistent with how financing leases are reported. The difference between the types of leases plays a major role in how the expense is recognized on the income statement. For financing leases the expense is shown as amortization of the leased asset. For operating leases, the expense remains the same as it is shown under the old standard, rent or lease expense.

FINANCIAL RATIOS

Based on the change in how the operating leases will be reported various ratios will be affected that many users of construction financial statements use as a basis to analyze contractor's financial stability. Debt to equity ratio is used to determine how leveraged an entity is. For most contractors a debt to equity ratio of 3 to 1 or less is considered acceptable. If an entity has a significant amount of operating leases this debt to equity ratio could significantly increase due to the additional debt included on the balance sheet. Another ratio that is important to outside users of the financial statements for contractors is the debt coverage ratio. This ratio is an analysis to see if the entity is covering the debt payments made by a contractor.

The normal ratio is a 1.25 to 1 calculated by the sum of the net income before taxes of an entity plus depreciation, amortization and interest, minus distributions to the stockholders, taxes paid and unfinanced equipment divided by the sum of the maturities of debt paid and interest. As the definition states amortization is added back in the numerator which addresses the capital lease debt however operating leases will not be charged to amortization, they will continue to be expensed to rent or lease expense. Additionally, the debt paid will have increased as a result of the reporting of the operating leases as debt on the balance sheet. Some financial institutions have modified the calculation for the debt coverage ratio to include the rent or lease payments made on operating leases into the numerator. It is important for a contractor to address this with their financial institution to ensure proper compliance with any covenant requirements included in their debt agreements.

EMBEDDED LEASES

Contractors need to be on the lookout for embedded leases. Embedded leases are included in contracts that a contractor may enter into. When a contractor enters into an agreement that has the following characteristics the entity is required to record an operating or capital lease on its financial statements:

- The asset is identified;
- The contractor entering into the agreement has the right to control the asset;
- The term is identified and will be 12 moths or greater; and
- There is consideration paid for the use of the asset.

For example, a general contractor enters into an agreement to rent a crane that will be attached to a building that is being constructed along with an operator of the crane. The crane has been identified as the asset, the general contractor controls how the crane will be used during the construction of the project, the term of the agreement is expected to be for 24 months, and the general contractor will pay monthly for the rental of the crane along with the cost of the operator. Based on this set of facts the general contractor has entered into a lease covered under ASU 842 and must record a right-to-use operating asset along with the corresponding debt on the balance sheet for the discounted present value of the lease payments.

CONCLUSION

The new lease accounting standard will have a significant impact on a contractors financial statements. Based on this, it is important for a contractor to take steps immediately to see how this new standard will impact the financial ratios of the entity. Once the impact is determined, contractors need to address how the outside users of the financial statements will determine the impact on financing, surety credit, and other uses of the financial statements.

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