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New Lease Accounting Standard: Deferred But Not Forgotten

By Robert Mercado and Michelle Johnson | Friday, April 30, 2021

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As a result of the pandemic, non-public companies were granted an extension to begin implementation of the new lease accounting standard, ASU 842. While public companies were required to implement the new standard with fiscal years beginning after Dec. 15, 2019, ASU 842 does not take effect for non-public companies until fiscal years beginning after Dec. 15, 2021. For most non-public companies, this means the fiscal year ended Dec. 31, 2022, with no change for interim periods until the entity's year-end.

ASU 842 will have ripple effects for many entities, including contractors. The new lease standard applies to any entity's lease or rental agreement where the term is in excess of 12 months. In the case of a term less than 12 months, ASU 842 does not apply.

CAPITAL LEASES

Currently, capital leases are recorded on a contractor's books as a long-term asset of property or equipment, with a corresponding liability equivalent to the present value of the future lease payments. The asset is amortized on a straight-line basis to the income statement as an expense, based on the shorter of the lease term or the useful life of the asset. As payments are made on the capital lease, the principal will be reduced and interest will be recorded on the income statement. On the cash flow statement, the payments made on the lease are reported as financing activities, and the amortization of the asset is reported as an adjustment to the operating activity.

Capital leases will, for the most part, remain the same under the new lease standard as compared to the former accounting standard. The new standard designates capital leases as financing leases, and the asset that is under lease will be shown on the balance sheet as a long-term asset called a "right-to-use asset." The lease will be considered a financing lease if a contractor enters into a lease meeting any one of the following criteria:

- transfers ownership of underlying asset;

- grants the option to purchase the underlying asset, and the lessee is reasonably certain to exercise this option;
- the lease covers a major part of the remaining economic life of the asset;
- present value of lease payments and any additional residual value guaranteed by the lessee equals or exceeds substantially all or more of the fair value of the underlying asset; or
- underlying asset is specialty in nature for the lessee and has no alternative use to the lessor at the end of lease.

OPERATING LEASES

If a contractor enters into a lease without meeting at least one of the above criteria, the lease will be considered an operating lease. Under the current lease accounting standard, operating leases are recorded on the contractor's books as either rent or lease expense. The property or equipment that is leased is not recorded as an asset, and the future lease payments are not recorded as a liability on the contractor's balance sheet. This is called off balance sheet risk. It equates to the contractor showing neither the asset nor the liability of amounts owed, unlike a capital lease which requires the asset and the liability to be reported on the balance sheet.

Under the new lease standard, operating leases will be recorded, much like financing leases, on the balance sheet; however, there are differences in how they are recorded on the income statement and cash flow statement.

On the income statement, the operating lease expense will be recorded as either rent or lease expense on a straight-line basis, which consists of amortization of the asset and interest paid on the lease. However, on the cash flow statement the expense is included in net income, not interest or amortization. This introduces various analytical issues that need to be prudently addressed.

ANALYTICAL ANALYSIS IMPACT

Most contractors have a line of credit or long-term debt with financial institutions that require the contractor to maintain certain financial ratios known as covenants. These covenants usually include a debt-to-equity ratio in addition to a debt coverage ratio. Additional debt recorded on the balance sheet will result in debt-to-equity ratios being negatively impacted.

Financial institutions typically calculate debt coverage ratio as net income plus depreciation, amortization, interest expense and taxes. This number is then divided by current payments on long-term debt, including leases recorded on the balance sheet, plus interest. The new lease standard permits additional debt payments to be included in the debt coverage ratio, but the interest and amortization relating to the operating leases, which is now recorded as rent or lease expense (as opposed to amortization

and interest), will not fall under the current definition of the financial institution's covenants. This unfortunately creates the potential for many contractors to fail to meet the specified criteria.

Surety credit also may experience potential impacts due to the new ASU 842 lease standard. Surety credit revolves around a contractor's working capital. Currently, the portion of the operating lease a contractor is obligated to pay is not included in the working capital. Once the new standard is implemented, working capital will be negatively affected based on the amount of operating lease obligations due in a one-year timeframe from the date of the balance sheet. This could represent significant deficits regarding surety credit acquisitions, as criteria are based on a multiple of 10 times to 20 times the contractor's working capital.

CONCLUSION

Although the new lease standard implementation has been deferred, it's imperative that contractors review current and future lease agreements to proactively position and prepare the entity's financials. Once the contractor understands the impact of the new lease standard, the contractor can assure all financial institution and surety criteria are within reach. Contractors with strong accounting and legal counsel can mitigate the impact of the accounting changes ahead of time and eliminate any potentially damaging financial shortfalls on the balance sheet, hence allowing for covenants to be met.

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