

CHANGES TO LEASE ACCOUNTING COULD IMPACT CONTRACTORS' FINANCES

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Changes to Lease Accounting Could Impact Contractors' Finances

By Christopher E. Hartle, CPA, Senior Manager / Team Leader

In the current economic climate, contractors are fighting for every project they get. Many have lowered margins, reduced overhead or moved to a new geographic area in an attempt to weather the storm. Some will soon face another challenge: a rising debt-to-equity ratio that may make it more difficult to obtain bonding and financing.

The changes to those contractors' financial information stem from proposed changes to lease accounting that would require them to record an asset and a liability on property they lease. It is expected to create an increase in assets but a greater increase in liabilities and financial leverage.

For contractors who frequently use leases to finance equipment, these changes likely will make their balance sheet less attractive. Contractors who often replace expiring leases with new ones may also see a negative impact on their income statement due to the higher amount of interest expense recognized early on in a lease from the use of the effective-interest method when amortizing the lease liability.

THE SETUP

On August 17, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly developed a draft standard on lease accounting which attempts to ensure assets and liabilities arising from lease transactions are recognized in the statement of financial position. These changes were a result of too much financial risk that was not reflected on the statement of financial position.

Under current accounting standards, a lessee classifies and accounts for a lease under one of two ways: operating lease or capital lease. Capital leases transfer substantially all of the risks and benefits of ownership to the lessee as if the lessee borrowed the money to purchase the property. Capital leases are treated similarly to a purchase of the underlying asset which would require the lessee to recognize an asset for the property leased and a corresponding liability for the rental obligation in the statement of financial position. The lessee depreciates the leased asset and apportions lease payments between financing charges and a reduction of the liability. Operating leases are all other leases that are not classified as capital leases. They are generally treated as rental of property, and the effects are recorded as rent expense over a straight-line basis over the term of the lease.

Currently, a lessor classifies a lease as an operating, sales-type, or direct financing lease. Sales-type and direct financing leases are types of capital leases in which substantially all of the risk and benefits of ownership of the leased property transfers to the lessee. If a lease does not include a profit component (the fair value of the underlying property equals the carrying value), the lease is classified as a direct financing lease. Otherwise, it is classified as a sales-type.

The proposed changes would require, at the date of inception of the lease, the lessee to record an asset representing its right to use the leased property (underlying asset) for the lease term. The lessee would also record a corresponding liability for its obligation to make the lease payments. The liability would be calculated by taking the present value of the lease payments over the most likely lease term, including any renewable or termination options. The right-of-use asset would then be amortized over the shorter of the expected lease term or the useful life of the underlying asset. The lessee would also incur interest expense on the liability to make the lease payments.

For lessors, how they record the lease transaction is determined by whether they retain exposure to significant risks or benefits associated with the underlying asset. If they do retain the exposure to significant risks or benefits, then the lessor shall apply the performance obligation approach to the lease. If the lessor does not retain exposure to significant risks or benefits, then the lessor shall apply the derecognition approach to account for the assets and liabilities arising from the lease.

Under the performance obligation approach, at the date of lease commencement, the lessor will record an asset for its right to receive lease payments and a lease liability. The lessor would not derecognize the underlying leased asset. The lessor then would recognize interest income from the right to receive lease payments and lease income as the lease liability is satisfied.

At the commencement of a lease accounted under the derecognition approach, the lessor would record an asset for its right to receive lease payments. The lessor would also derecognize the portion of the carrying amount of the underlying leased asset that represents the lessee's right to use the underlying asset during the term of the lease. The portion of the rights in the underlying asset that the lessor retains will be reclassified as a residual asset. On the income statement, the lessor would recognize lease and interest income from the lease payments and a lease expense for the costs of the portion of the underlying asset that is derecognized at the date of the commencement of the lease.

THE IMPACT

These changes could have a significant impact on construction entities that do a lot of financing through operating leases.

The Georgia Tech Financial Analysis Lab conducted a study based on 2006 financial statements in an attempt to quantify the impact of "capitalizing" all operating leases. Among their findings was an increase in operating cash flow, an increase in financial leverage and a decrease in return on assets. The study determined the median increase in assets (14.6%) was overshadowed by the median increase in liabilities (26.4%) and the median increase in financial leverage (26.4%).

Further, the Equipment Leasing and Finance Association (ELFA) did an analysis of the impact on lessees, which showed that the longer the lease term, the greater the impact of the front ending of lease costs. For a three-year lease, the first-year lease cost is higher than straight line by 7 percent. In a 10-year lease, the first-year lease cost is 21 percent higher.

Due to the impact of the lease accounting changes, we will likely see lessees desire shorter term leases to reduce both the increased leverage and the impact of the increase in first-year lease costs. Lessors may be inclined to charge a higher price on leases to offset the additional risk they would be subjected to with shorter term leases.

These changes likely will not become effective until 2012. There are some actions that can be taken now to quantify and possibly reduce the impact:

- Determine if this is going to have a major impact on your business. If you lease a significant amount of assets, this accounting change is likely to have a larger impact on your financials.
- Quantify the impact of the proposed changes by considering all existing and potential future operating leases.
- Review and analyze how your corporate agreements (e.g. loan documents, compensation agreements, etc.) are affected and if the agreements can and should be amended to take into consideration the changes solely due to the changes in lease accounting.

For more information on the proposed changes and how they impact your company, please contact me at chartle@barnesdennig.com or call 513.241.8313.

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Chris leads the firm's construction client service team, offering valuable insight and expert recommendations into issues from financing to operations to employee benefit plans. He is adept at not only helping his clients strengthen their bottom line but also understand the strategies that make such success possible.

In his 13 years at Barnes Dennig, Chris has worked closely with a number of clients to identify accounting improvements and streamline their processes and systems. He has a particular expertise in information technology, helping clients utilize their accounting software to its fullest capability. He also manages an engagement team for employee benefit plan audits.

In every role, Chris's goal is to educate his clients along the way, helping them gain a deeper understanding of the accounting requirements they face and the many ways it can impact a company.

He is a member of the editorial advisory board of *ProfitCrew*, which provides regular and insightful content for the construction industry. He also serves on Barnes Dennig's Accounting and Auditing Quality Control Committee. In this role, he helps the firm deliver the highest quality assurance services, which in turn provides clients with increased peace of mind.

Chris graduated from Miami University with a double major in accounting and finance. He is a Certified Public Accountant (CPA) licensed in Ohio and is a member of the Ohio Society of Certified Public Accountants (OSCPA) and the American Institute of Certified Public Accountants (AICPA).