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The Exposure Draft addresses lease accounting for both lessors and lessees. This article focuses on the accounting impact on lessees. Topic 840 will supersede the current rules on lease accounting, formerly known as FASB Statement 13, “Accounting for Leases,” released in 1967.

For simplicity, we will refer to the current lease accounting standards by their precodification title, FASB 13.

The Exposure Draft is open for comment through December 15, 2010 and a final standard will probably be issued by mid-2011. The effective date is anticipated to be sometime in 2012.

The Exposure Draft is an update from the initial discussion paper released by the Boards in March of 2009. The updated Exposure Draft has significant changes from the initial discussion paper.

It proposes significant changes to accounting for all leases other than leases of intangible assets, leases of biological assets, and leases to explore for use minerals, natural gas, or similar nonrenewable assets.

The principles used throughout the Exposure Draft focus on the right to use an asset for the lease term, with a corresponding obligation to pay for the use of that asset.

FASB 13 Basics

First, let’s take a quick look at current lease standards before we analyze the
potential impact of the new proposed guidance. FASB 13 governs whether a lease is treated as an operating lease (off-balance-sheet) or an on-balance-sheet capital lease, hereafter referred to as a financing lease.

A financing lease is defined as one that transfers substantial risks and rewards incidental to ownership of the asset to the lessee. Financing leases require that payments for the right to use the asset and the obligation to pay for the asset be accounted for as an asset and a liability on the face of the balance sheet.

The asset is depreciated similar to owned assets and the liability is recorded similar to a loan with current and long-term portions presented separately on the balance sheet. Payments are applied to principal and interest expense using the effective interest method.

FASB 13 outlines four criteria for determining if a lease is treated as operating or financing. If the lease agreement cannot be cancelled and meets any one of the following tests, then the lease is a financing lease:

1) There is a transfer of ownership.
2) There is a bargain purchase option; this is defined as a purchase option substantially below market value.
3) The term of lease is greater than 75% of the asset’s useful life.
4) The net present value of future lease payments is greater than 90% of the fair value of the underlying asset.

**Why the Change?**

Operating leases have often been criticized by the SEC and the international financial community as being a form of off-balance-sheet financing. Other critics point out that the use of bright-line tests, where a mathematical calculation determines lease presentation, is arbitrary.

Operating leases receive criticism partly due to the fact that the right to use the underlying asset and the contractual obligation to pay the lessor are not recorded on the balance sheet. The payments to use assets under operating leases are simply expensed as paid and only a disclosure to commitments is made in the footnotes to the financial statements.

See Example 1 for a comparison of the financial effects of a five-year operating lease and a five-year financing lease. The example assumes a five-year term, a $5,000 monthly payment, and an incremental borrowing rate of 7.42%.

Many critics contend that financial managers can structure their leases to keep them off the balance sheet so stakeholders have a difficult time understanding the financial position of a company. Whether this is true in practice, uncertain financial times cause many to believe that taking another look at operating leases may be warranted.

**The Standard Setters’ Solution**

The new guidance proposed in the Exposure Draft would eliminate operating leases where a right to use an asset and
an obligation to pay for the right of use exists. Although the Exposure Draft would most significantly impact the accounting treatment of operating leases, accounting for financing leases would also change.

**An Asset & Liability Approach**

The new standard would propose an “asset and liability” approach to leases. The right to use an asset that will produce future cash flow meets FASB’s definition of an asset and should therefore be recorded on the balance sheet. The future use of that asset should then be depreciated over its period of contribution to cash flows, which will equal the longest possible lease term that is more likely than not to occur.

Similarly, the obligation to pay for use of an asset meets the definition of a liability and should be recorded as such. Payments against that liability should also include an element of interest to pay for the financing aspect of the transaction.

**Complex Leases**

Leases considered to be complex will bring added difficulties and uncertainties. If leases are complex and contain options to extend, contingent rental payments, or a guaranteed residual value, such variables would be analyzed based on the “most likely” principle and would add complexities when accounting for them.

The lessee must determine the most likely result and account for the related asset and liability accordingly. Measurement of leases will be based on the:

- Longest lease term that is more likely than not to occur,
- Discounted probability weighted cash flows, and
- Reassessment and remeasurement when facts or circumstances change.

**Noncontractual Factors**

Noncontractual factors that would affect the term of the lease should also be taken into account. These include business plans, importance of a leased asset, and past practices.

These contractual and noncontractual factors should help shape the probability assessment. In many cases, this will be a straightforward exercise in assessing whether a lease extension option is more likely than not to occur.

Example 2 includes a five-year lease term with two five-year renewal periods. In this situation, the 10-year term is the longest option that is more likely than not to occur, as there is a 60% chance that the term of the lease will be extended at least to the 10-year option.

Once the longest more-than-likely lease term is calculated, the possible outcomes within the lease term should be identified,
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and a probability-weighted present value of lease payments should be calculated.

The existence of contingent rentals or guaranteed residual values will also impact the cost of the asset recorded once the lease term is calculated. The lessee does not need to search for all possible outcomes, but those outcomes which can reasonably be assessed should be included.

A typical example will be contingent rentals based on sales or guaranteed residual values that vary greatly depending on hours of use. See Example 3 for an illustration of how to calculate the probability-weighted present value on a lease with a guaranteed residual value.

Once the lease term and probability-weighted cash flows are determined, the lessee should use its incremental borrowing rate for the purposes of calculating present value. The lessee's incremental borrowing rate is typically the rate for which the lessee could borrow money over a similar term with similar collateral. If the lessee's incremental borrowing rate is not able to be determined, then the lessor's stated interest rate can be used.

When calculation of the lease term and the present value of lease payments have been completed, an asset and a liability can be recorded. The asset is recorded at the present value of the calculated lease payments.

Purchase option costs are not included in the calculation of probability-weighted present value. The liability is accounted for using the effective interest method similar to financed debt being amortized. The asset is depreciated over the shorter of the useful life or lease term.

Lease Reassessments

Subsequent to the initial measurement, a reassessment of the facts and circumstances surrounding the lease must be performed at each reporting period. If the facts and circumstances change and would have a significant impact on the recorded asset or liability, then an adjustment is required.

The reassessment must recalculate the expected lease term and adjust the asset and liability accordingly. Example 4 illustrates a change in the estimated lease term, and includes a five-year lease with a five-year option to extend. The option is determined more likely than not to occur with the reassessment occurring in Year Three. The example assumes a $5,000 monthly payment and an incremental borrowing rate of 7.42% in the extension period.

The reassessment of leases is necessary when a significant change in contingent rentals, guaranteed residual values, or term option penalties arise. When such a reassessment occurs, the evaluation must consider the effects of such changes to current, prior, and future periods. Any changes that result in different lease payments in the current or prior periods must be recorded in net income. Changes that may affect future periods would be recorded as changes to the right-of-use asset and related liability.
Example 5 illustrates a change in contingent rental, and includes a five-year lease based on sales volume and an incremental borrowing rate of 7.42%. The related journal entries are presented for illustrative purposes, highlighting the Year-One initial assessment and the Year-Two reassessment adjustments.

Note that the depreciation and interest in Year Two doesn’t change. In addition, the entire amount of reassessed expense in current and prior periods is recorded as contingent rent expense.

In Years Three-Five, the additional liability is amortized using the original incremental borrowing rate and the effective interest method. Finally, the additional asset is depreciated over the remaining lease term.

**The Implications of the New Standards**

It’s important to identify the impact of the proposed accounting changes and to understand how these may impact financial reporting. The new guidance proposed in the Exposure Draft affects the accounting and reporting of leases under GAAP.

The proposed changes will not affect cash flows and have no effect on existing tax law. The only changes are on a company’s GAAP-based financial statements and may result in changes to the business practices and terms for leasing arrangements.

**Income Statement Clarification**

The proposed new guidance will have significant implications on income statement classification. *Repercussions are likely to impact both job costing and estimating.*

Companies utilizing operating leases currently record the entire charge to the income statement, which may or may not have been applied to job costs.

If contractors are applying operating lease expenses to job costs or to calculate their overhead, but exclude the cost of capital and depreciation, issues may arise concerning the consistency of their job costing.
Rhonda Kay, CFO of GH Phipps Construction Companies, notes: “The change in lease standards will have a significant effect on our internal financial reporting, job costing, and estimating that will take time to integrate. The changes will also affect standard benchmarks – both internally and externally – which will require another adjustment period both for us and our key partners.”

**Federal Acquisition Regulations**

Government contractors subject to FARs may also have issues regarding operating leases. Under the current regulations, operating leases are allowed under FAR 31.205-36 “Rental Costs” (as defined by FASB 13) to be included in a contractor’s billing rate.

Government contractors are allowed to include certain costs for depreciation in a financing lease. However, interest and finance costs are unallowable when developing billing rates. This means that operating leases provide a significant advantage to certain government contractors in developing billing rates to recoup finance charges.

**Operating Ratios**

Additionally, the proposed changes will affect operating ratios for many companies, and those companies that utilize Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) ratios will be particularly affected.

Those currently using operating leases will see increases in EBITDA, as payments for leases that were previously included in rent expense accounts will now shift to depreciation and interest, both of which are excluded from the determination of EBITDA.

“The adequacy and quality of working capital are essential components in the surety’s determination of bonding programs,” says Rusty Lear, Surety Director & Executive VP of Flood & Peterson Insurance, Inc.

“The proposed reclassifications may have a significant (if not detrimental) impact on working capital and the resulting bonding program, yet the underlying lease obligations remain unchanged.”

Furthermore, debt service coverage ratios, debt to equity ratios, and net worth calculations could also negatively affect bank covenants. The implications for users of operating leases are far-reaching. Addressing these implications early will be paramount to ensure any negative impacts are mitigated and managed properly. Companies should perform financial forecasting and modeling to understand the sensitivities of applying the new proposed guidance.

Example 6 involves two scenarios for a $75 million-revenue contractor. The first scenario includes $3 million in operating lease expenses with no financing leases. The second shows the same contractor with the same $3 million in financing lease payments.

The examples assume a five-year term with a 7% incremental borrowing rate. Note that EBITDA more than doubles, while debt to equity increases over 70%. Working capital decreases by over $2 million and the current ratios decrease 14%.

Marc Hendrikson, CCIFP, VP with Citiwide Banks, says: “When setting up lending arrangements with operating companies and setting corresponding covenants (particularly with contractors), bankers usually identify a few key financial metrics to set trigger mechanisms that will protect both the client and the bank’s position as the lender.” He continues: “In this vein, debt and equity measures are of primary concern, secondarily working capital, sometimes debt coverage ratios, and rarely maximum capital expenditures covenants.

“With the new lease accounting rules in place, operating leases that might be identified as new finance leases in the financial statements have the potential to immediately trigger several covenant defaults even if overall cash flow is not impacted and, in reality, the client’s overall financial situation has not changed from an operational point of view. “This tends to be particularly exacerbated in smaller, closely held companies where equity and working capital trends are often tight for a variety of reasons, not the least of which includes tax planning, ownership, or other issues.”

**Other Changes**

The changes in the standards can also have far-reaching effects on shareholder distributions, employee bonus structures, and management profit sharing plans. It is not uncommon for companies to compensate shareholders or employees based on EBITDA or a modified version of EBITDA (Adjusted EBITDA).

In an open-book management setting, shareholders and employees may see a significant increase in EBITDA, with the expectation that a significant increase in distributions or compensation will also be forthcoming. Companies that distribute based on EBITDA may want to reevaluate their policy in light of the modified standards proposed in the Exposure Draft.

“These reclassifications risk altering the composition of the balance sheet to the point it presents credit partners with a more leveraged financial position than what may actually exist,” adds Lear.
“Operating leases offer contractors the discretion needed to adapt their equipment resources to the changing needs of their projects and work programs. Footnotes in the financial statements generally provide the necessary transparency and disclosure of financial obligations to make sound credit decisions under the current standards.”

Under the current standards, a company using operating leases is insulated from impairments since no assets or liabilities are recorded. The charge for rental expense related to the asset will continue to be paid in accordance with the lease whether or not supporting revenues exist, but the expense timing will be straight-lined in most cases.

In the current economic environment, many contractors are required to analyze their long-term assets for potential impairment based on expected cash flows from those assets. In many cases, contractors are determining that impairment exists and a portion of the asset is written off the balance sheet through expense. The related debt is obviously unchanged and a potentially major shift in debt to equity can occur.

Under the proposed standards, all companies would be subject to impairment analysis for long-lived assets and the current discrepancy would no longer exist between owners of assets and lessees. Short-term leases, defined as 12 months or less, may be accounted for by recording assets and liabilities at their undiscounted amounts.

**Proactive Opportunities**

As the CFM, you should first determine how your surety or bank treats operating leases and if they are aware of the scope of your current leasing arrangements. (Many may already adjust for leases in their internal analysis.) Next, recalculate your covenants and/or bonding capacity assuming the changes contemplated by the Exposure Draft. Note the effect to your key ratios and consider “stress testing” these ratios to determine how sensitive they may be.

With almost two years until the new proposed guidance is expected to take effect, now is a great time to revisit how buy and lease scenarios are evaluated. If your company’s current policy tends toward operating leases, reassessing that policy may be a worthwhile exercise.
With asset-related leases having a balance sheet impact, it will be imperative that CFMs and equipment and facility purchasing managers work together. After all is said and done, operations, finance, and strategy must align in order to develop asset acquisition plans and execute asset lease or purchase agreements.

Without proactive planning, balance sheets will react to asset needs in the field, putting key ratios at risk. Modeling the impact of the proposed standards to the most recent financial and forecast reports will greatly benefit companies in understanding the true impact of these proposed changes.

Sharing the model with your key stakeholders will also help ensure that non-compliance with bank covenants or potentially harmful reductions in bonding capacity are avoided.

As with any significant change in accounting standards, it often takes a period of time for key stakeholders to adjust and become comfortable with the new ratios and the impact on financial statement presentation.

**Bank Agreements**

If new bank agreements are being negotiated, it may be mutually beneficial to include a clause that all covenants are to be calculated using GAAP in existence at the date of agreement or, alternatively, that if new standards for leasing are enacted, the company and the bank agree to set agreeable revised covenants.

Such a clause eliminates the effect of the potentially unknown changes that may come into effect in the middle of the contracted period. The proposed changes are excellent examples of changes that are not fully known at this time, but that could have significant effects on the calculation of debt covenants in the future.

Hendrikson notes: “Contractors are especially vulnerable to these potentially large swing factors due to the heavy impact that equipment and fixed assets typically have on their operations. Ultimately, if the contractor is strong, then the impact of the new rules will not be material nor will they trigger any covenant defaults.”

**Sureties & Bonding**

Bonding agents and sureties will greatly benefit by seeing the effects of the potential changes if the impacts can be seen over a period of years vs. absorbing the front-loaded charges in one year. Companies that can model and illustrate the effect over the period of lease terms will be able to show little change in the long run and that cash out of pocket is not affected.

“We are concerned with the ability of all contractors to achieve the necessary level of financial modeling. The capabilities of a construction firm, when determining surety credit, are heavily weighted on the financial performance of construction contracts,” says Lear.

“Estimators and financial executives will be challenged to adapt their job costing for leased equipment under the new standards with consistency and accuracy when applying modeling and weighted probabilities in building project budgets.

“This may also lead to inaccurate interpretations of financial performance, and hinder a contractor’s ability to project its future cash positions – a contractor’s lifeblood.”

If your company does not currently make use of financial forecasting models, you may want to contact your CPA. (Better yet, the use of a CPA with a CCIFP designation will ensure that the model is built with the specific needs of contractors, construction-focused bankers, bonding agents, and sureties in mind.)

**Conclusion**

The construction industry as a whole is a leader when it comes to proactive, forward-looking risk management. Considering the impact of potential occurrences given known current circumstances is always a best practice.

Applying the same principles to potential changes in accounting standards will help organizations prevent undesirable and unnecessary consequences. In the meantime, CFMA will be among several associations responding to this Exposure Draft. (Go to www.cfma.org for additional information.)

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