ASC 842 – Implementing the New Leasing Standards for Contractor Financial Statements

Agenda

- Where We Are
- Why Change?
- What’s It All About?
- Comparison
- Two Methods for P&L Recognition
- Operating Lease Example
- Disclosures
- Transition
- Why Do We Care?
- Conclusion
Where We Are

• ASU 2016-02 – Leases (Topic 842)
• Public companies – effective for fiscal years beginning after 12/15/18 – early adoption permitted
• Nonpublic companies – years beginning after 12/15/20 (new proposal from FASB) (early adoption permitted)
• Requires retrospective application (opening balance sheet potential changes)

Where We Are (Continued)

• The new lease accounting standard, Leases (ASC 842) promulgated by the Financial Accounting Standards Board (FASB) fundamentally changes the rules that govern accounting for both equipment and real estate leases.
Where We Are (Continued)

• FASB’s new standard requires companies to recognize the assets and liabilities resulting from leases of more than 12 months in duration based on the present value of lease payments. Among its many provisions, the new lease accounting standard also affects the disclosure requirements for the recognition of lease-related expenses and income.

Where We Are (Continued)

• The finalized lease accounting standard as mentioned earlier was issued with an effective date for public companies for fiscal years beginning after December 15, 2018 and for private companies after December 15, 2019.
Where We Are (Continued)

- As indicated, the new standard is already in effect for public companies for their fiscal years beginning after December 15, 2018. Although early adoption of this standard was allowed, ONLY TWO PUBLIC COMPANIES CHOSE TO DO SO (Microsoft and Target), an indication of the complexity involved.

Where We Are (Continued)

- On July 17, 2019 the FASB voted to propose to delay the effective date for nonpublic companies until fiscal years beginning after December 15, 2020. On August 15, 2019, they issued the proposal for public comment. It is expected to be delayed as indicated.
Where We Are (Continued)

• USE THIS NEW DELAY WISELY AND GET READY TO IMPLEMENT!

Where We Are (Continued)

• The changes required by this new standard will impact traditional financial analysis of contractors, affecting the income statement and balance sheet presentation, working capital, and debt/equity ratios, and are also expected to create challenges to loan debt covenants.
Why Change?

- For years, many have stated that off-sheet balance sheet financing achieved via leases distorts the true financial picture of a company.

How so you might ask?

Why Change?

- In substance, the assets being leased have been missing from the balance sheet
- In turn, the liabilities associated with these assets have also been missing from the balance sheet
Why Change?

• In essence this has been achieved by leasing companies helping companies structure leases that missed being capitalized by the “skin of their teeth”

Why Change?

• IASB, now the apparent big brother to FASB, said enough and convergence is here
What’s It All About?

• The new standard calls for changes for both financing leases (formerly called capital lease obligations), and operating leases. While calculations involved in analyzing financing leases haven’t changed dramatically, the biggest impact will come from the change in accounting for operating leases.

What’s It All About?

• Prior to the new standard, operating lease rents were reported on the income statement, and future minimum lease payments were disclosed in the financial statement.
What’s It All About?

• The new standard requires the annual rents for operating leases to be capitalized and reported on the balance sheet as an asset with a corresponding liability for the future minimum lease payments.

What’s It All About?

• The new standard requires that operating leases be analyzed to break them down into noncurrent lease assets and current and noncurrent liabilities for presentation on the balance sheet.
Comparison

- **Current Treatment:**
  - Capital leases - the Asset & Liability are on the balance sheet
  - Operating leases - Asset & Liability aren’t on the balance sheet – rent expense is recorded on the income statement.

Comparison

- **NEW Treatment:**
  - Capital leases - the asset and liability are on the balance sheet (basically, no difference). **Terminology changes** from capital lease to a **finance lease**.
  - Operating leases – the asset and liability **WILL BE** on the balance sheet
Comparison (Continued)

Old Rules for Capital Leases:
• Qualitative criteria considered include:
  1. Ownership is transferred by the end of the lease term; or
  2. The user has a purchase option at a price sufficiently below fair value such that the user is expected to exercise it; or

Comparison (Continued)

Old Rules for Capital Leases (continued):
  3. The lease term is at least 75% of the property’s estimated remaining life; or
  4. The present value of the minimum lease payments is at least 90% of the fair value of the asset; or
Old Rules for Capital Leases (continued):

5. The assets are so specialized that only the user can use them without major modifications.

6. The 75% and 90% tests do not apply if the lease term begins within the last 25% of the leased property’s estimated economic life.

New Rules for Finance Leases:
Throw out the old “bright line” rules above and substitute as follows:

1. The lease transfers ownership on or before the end of the lease term.

2. The lease gives the lessee an option to purchase the asset, and the lessee is reasonably certain to exercise that option.
Comparison (Continued)

New Rules for Finance Leases (continued):

3. The lease term represents the major part of the remaining economic life of the lease assets (except if near the end of its economic life)
4. The present value of the total lease payments and any residual payment equals or exceeds the fair value of the asset, or

Comparison (Continued)

New Rules for Finance Leases (continued)

5. The asset is so specialized that it isn’t expected to have an alternate use at the end of the lease.
Comparison (Continued)

Looks pretty similar, right?
The main changes have to do with the “majority” of economic life rather than “75 percent” of the economic life, and present value “equaling or exceeding” the fair value of the asset as opposed to “90 percent” of the fair value.

Comparison (Continued)

Old Rules for Operating Leases:
Report as rent expense on the income statement and appropriate disclosure on terms in the notes to the financial statements.
Comparison (Continued)

New Rules for Operating Leases:
Virtually all leases will be capitalized on the balance sheet
Exception are leases with maximum term of 12 months or less (including renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor)

Comparison (Continued)

New Rules for Operating Leases (continued):
For an operating lease, a “right of use asset” and a “lease liability” must be now be recognized.
The lease liability is calculated as the sum of the present value of the rest of the lease payments, using a discount rate
Comparison (Continued)

New Rules for Operating Leases (continued):
Lessees should use the borrowing rate that is implicit in the lease if it can be determined.
If it cannot be determined, the lessee will use their incremental borrowing rate (IBR).
There are consequences of using an inaccurate rate.
There is another option available for a nonpublic company.

Comparison (Continued)

New Rules for Operating Leases (continued):
Nonpublic companies can elect an accounting policy to use a “risk-free” discount rate at the date of commencement of the lease. That will usually be the U.S. Treasury yield rate for a similar lease length. For example, in June of 2019, the U.S. Treasury yield rate for a five-year term was 1.8 percent, a seven-year term was 1.93 percent, and a ten-year term, 2.07 percent. This may be easier to determines as these rates are published daily.
Comparison (Continued)

New Rules for Operating Leases (continued):

• The “right of use asset” is computed as the lease liability, measured at the commencement date of the lease, any other lease payments made on or before the commencement date, and any other initial indirect costs the lessee may have incurred. In the majority of cases, the “right of use asset” and the “lease liability” will be the same amount.

Comparison (Continued)

New Rules for Operating Leases (continued):

• The contractor has the option to perform and record the calculation as of the first day of their current year and to present comparative information under the prior method. In the alternative, they may go back and recalculate as of the first day of the comparative year, presenting both years under the new standard.
Comparison (Continued)

New Rules for Operating Leases (continued):

• In either case, calculations on previously existing leases will require recording the resulting change to equity as a prior period adjustment. We expect the majority of contractors to elect to perform the calculation as of the first day of their 2020 (now 2021) fiscal year.

Comparison (Continued)

New Rules for Operating Leases (continued):

• Lease payments include fixed payments, any variable payments tied to an index, the exercise price for a purchase option that is reasonably certain to be exercised, and penalties for terminating the lease if the lessee is reasonably certain to terminate a lease.
Comparison (Continued)

New Rules for Operating Leases (continued):

• If the lease is considered to be short-term (twelve months or less as of the commencement date), the lessee can elect not to recognize a “right of use asset” and corresponding “lease liability” and may treat all lease payments as expenses.

Comparison (Continued)

New Rules for Operating Leases (continued):

• All operating leases with related parties, such as leasing of land, buildings, and equipment, will fall under the standard.
Two Methods for P&L Recognition

1. Financing Lease (old term Capital Lease)
   • Applies to any Property
   • Front-end loaded recognition with interest and amortization of property....meaning heavy expense on the front-end just like amortization looks on a Note Payable.

Two Methods for P&L Recognition

1. Financing Lease (continued)
   • Recognize right of use asset and lease liability initially measured at the present value of minimum lease payments.
   • Recognize unwinding of discount on lease as interest separately from amortization of Right-of-Use Asset
Two Methods for P&L Recognition

1. Financing Lease (continued)
   • No change to cash flow statement. Payment of interest portion reflected operating activity and principal payments reflected as financing activity.
   • ROU asset and liability for financing leases presented separately on balance sheet from operating leases or disclosed in notes.

Two Methods for P&L Recognition

2) Operating Lease
   • Applies to all Property
   • Straight line effect—much the same as operating lease effect on Income Statement. However, accomplished by increasing amortization of the right-of-use asset as interest expense on liability declines over the lease term.
Two Methods for P&L Recognition

2) Operating Lease (continued)

- Recognize right of use asset and lease liability initially measured at present value of minimum lease payments.
- Recognize a single lease cost, combining the unwinding of discount on lease liability with the amortization of the Right-of-Use Asset on a straight-line basis.

2) Operating Lease (continued)

- Right of use assets and related liabilities for operating leases presented separately from financing leases ROU asset and liabilities on balance sheet or disclosed in notes.
Let’s assume a five year (60 month) lease, with monthly payments of $5,000.00, no purchase option, with no other payments due. The lease term and first payment begin on January 1, 2021.

If we use the U.S. Treasury five-year rate of 1.8 percent in our example, a present value calculation results in a lease liability of $287,120.66.

The calculation for the lease appears below:

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
<th>Amount</th>
<th>Number</th>
<th>Period</th>
<th>End Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Lease</td>
<td>01/01/2021</td>
<td>287,120.66</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Lease Payment</td>
<td>01/01/2021</td>
<td>5,000.00</td>
<td>60</td>
<td>Monthly</td>
<td>12/01/2025</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Lease Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>lease</td>
<td>01/01/2021</td>
<td></td>
<td>287,120.66</td>
<td></td>
</tr>
</tbody>
</table>
In our example, the liability and the right of use asset have the same value.

So, we start out by recording an operating lease right of use asset of $287,120.66 and a lease liability of the same amount on the balance sheet.

In the first year, under the old rules, we would have recorded $60,000.00 of lease payments as rent. Under the new rules we amortize the “right of use asset” on a straight line basis.

The amortization expense each year is $57,424.13 ($287,120.66 divided by 5).
The lease liability is reduced by the lease payments made, and the excess of the lease payment over the calculated discount is recorded as interest expense. For the first year, that would represent $4,275.69.

Operating Lease Example

The table appears below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Lease</th>
<th>Lease Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2021 Totals</td>
<td>287,120.66</td>
<td>60,000.00</td>
<td>4,275.69</td>
<td>55,724.31</td>
<td>231,396.35</td>
</tr>
<tr>
<td>2022 Totals</td>
<td>0.00</td>
<td>60,000.00</td>
<td>3,702.19</td>
<td>56,297.81</td>
<td>175,098.54</td>
</tr>
<tr>
<td>2023 Totals</td>
<td>0.00</td>
<td>60,000.00</td>
<td>2,680.43</td>
<td>57,319.57</td>
<td>117,778.97</td>
</tr>
<tr>
<td>2024 Totals</td>
<td>0.00</td>
<td>60,000.00</td>
<td>1,640.10</td>
<td>58,359.90</td>
<td>59,419.07</td>
</tr>
<tr>
<td>2025 Totals</td>
<td>0.00</td>
<td>60,000.00</td>
<td>580.93</td>
<td>59,419.07</td>
<td>0.00</td>
</tr>
<tr>
<td>Grand Totals</td>
<td>287,120.66</td>
<td>300,000.00</td>
<td>12,879.34</td>
<td>287,120.66</td>
<td>0.00</td>
</tr>
</tbody>
</table>
Total expense in the first year in our example, is therefore $57,424.13 of amortization expense and $4,275.69 of interest, for a total of $61,699.82.

Why is this more than the $60,000.00 of payments?

Because the lease payment is due on the first date of the term.

Going back to our amortization table, we find the following results for the balance sheet:

Operating lease right of use asset - $287,120.66, less accumulated amortization of $57,424.13, a net $229,696.53 additional noncurrent asset on the balance sheet.
Our operating lease liability balance is $231,396.25, with a current maturity of $56,287.91, and a noncurrent maturity of $175,108.34.

Can you already see the issue?

A noncurrent asset of $229,696.53.

A current liability of $56,287.91, and a noncurrent liability of $175,108.34.

Let’s say our contractor had the following balance sheet numbers and ratios before the calculation of the operating lease right of use asset and liability:

- Total current assets: $500,000.00
- Total assets: $1,250,000.00
- Total current liabilities: $200,000.00
- Total liabilities: $750,000.00
- Total equity: $500,000.00
Original ratios:

Working capital:

$500,000.00 less $200,000.00, or $300,000.00 (ratio of 2.5 to 1)

Debt to equity:

$750,000.00 to $500,000.00, (ratio 1.5 to 1)

New balance sheet numbers:

Total current assets - $ 500,000.00
Total assets - $1,479,696.53
Total current liabilities - $ 256,287.91
Total liabilities - $ 981,396.25
Total equity - $ 498,300.28
Operating Lease Example

Original ratios:

Working capital:
$500,000.00 less $256,287.91, or $243,712.09 (ratio of approximately 2 to 1 and a drop in working capital of $56,287.91)

Debt to equity:
$981,396.25 to $498,300.28, (ratio of approximately 2 to 1)

Operating Lease Example

How will these changes impact bonding decisions, especially when factored for potentially multiple operating leases?

In addition, a contractor may find themselves in violation of debt covenants on their loan agreements. A violate of a debt covenant can cause the related debt to be classified as current unless the lender provides a waiver.
One more complication:

The treatment for income tax purposes has not changed, creating additional financial to income tax return differences, potentially resulting in additional deferred tax assets and liabilities.

Sample disclosures – Microsoft Annual Financial Statements – 9/30/2018 – Note 1:

“Leases:

We determine if an arrangement is a lease at inception. Operating leases are included in operating lease right-of-use (“ROU”) assets, other current liabilities, and operating lease liabilities in our consolidated balance sheets. Finance leases are included in property and equipment, other current liabilities, and other long-term liabilities in our consolidated balance sheets”
Disclosures

“Leases (continued):

“ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term”

Disclosures

“Leases (continued):

“As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. We use the implicit rate when readily determinable.”
“Leases (continued):

“The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for lease payments is recognized on a straight-line basis over the lease term.”
Sample disclosures – Microsoft Annual Financial Statements – 9/30/2018 – Note 16:

“Leases:
– “We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.
– The components of lease expense were as follows:”

Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16:

“Leases:
– Year ended June 30,
  • Operating lease cost $ x,xxx
– Finance lease cost:
  • Amortization of right-of-use assets $ xxx
  • Interest on lease liabilities $xxx
  • Total finance lease cost $xxx
Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16: "Leases:

- Supplemental cash flow information related to leases:
  - Cash paid for amounts included in the measurement of lease liabilities:
    • Operating cash flows from operating leases $x,xxx
    • Operating cash flows from finance leases xxx
    • Financing cash flows from finance leases xxx
  Right-of-use assets obtained in exchange for lease obligations:
    Operating leases xxx
    Financing leases xxx

Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16: "Leases:

- Supplemental balance sheet information related to leases:
  - Operating Leases:
    • Operating lease right-of-use assets $x,xxx
    • Other current liabilities $x,xxx
    • Operating lease liabilities x,xxx
    - Total operating lease liabilities $x,xxx
Disclosures

Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16: “Leases:

– Supplemental balance sheet information related to leases:

  - Finance Leases:
    - Property and equipment, gross $ x,xxx
    - Accumulated depreciation ( x,xxx)
    - Property and equipment, net $ x,xxx
    - Other current liabilities $ x
    - Other long-term liabilities x,xxx
    - Total finance lease liabilities $ x,xxx

Disclosures

Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16: “Leases:

– Supplemental balance sheet information related to leases:

  - Weighted Average Remaining Lease Term
    - Operating leases x years
    - Finance leases x years

  - Weighted Average Discount Rate
    - Operating leases x.x%
    - Finance leases x.x%
## Disclosures

Sample disclosures – Microsoft Annual Financial Statements – 6/30/2018 – Note 16: “Leases:

- **Supplemental balance sheet information related to leases:**
- Maturities of lease liabilities were as follows:

<table>
<thead>
<tr>
<th>Year Ending</th>
<th>Operating Lease</th>
<th>Finance Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30,</td>
<td>$x,xxx</td>
<td>$x,xxx</td>
</tr>
<tr>
<td>(FIVE YEARS LISTED)</td>
<td>$x,xxx</td>
<td>$x,xxx</td>
</tr>
<tr>
<td>Total lease payments</td>
<td>$x,xxx</td>
<td>$x,xxx</td>
</tr>
<tr>
<td>Less imputed interest</td>
<td>(xxx)</td>
<td>(xxx)</td>
</tr>
<tr>
<td>Total</td>
<td>$x,xxx</td>
<td>$x,xxx</td>
</tr>
</tbody>
</table>

## Transition

- The boards considered 3 approaches:
  - Full retrospective approach (let’s not even go there . . .)
  - Modified retrospective approach
  - Prospective approach
Transition (Continued)

• Modified retrospective approach....finally, a voice of reason!
• Applies to each lease that existed at the beginning of the earliest comparative period presented in the financial statements and any leases entered into after that date.
• In short, the lease liability is calculated as the present value of the remaining minimum lease payments + residual guarantee using discount rate at earliest period present.

Transition (Continued)

• Prospective Approach (most expected to use):
• Applies to each lease that existed on the first day of the fiscal year that starts after the indicated requirement date (now 12/15/2020 for nonpublic)
• The lease liability is calculated as the present value of the remaining minimum lease payments + residual guarantee using discount rate as of the first day of that fiscal year.
Transition (Continued)

• What should contractors be doing in 2019 and 2020 to prepare for the new lease standard? They should be undergoing a detailed analysis of all leases to determine the impact on their financial statements. They should be comparing changes in ratios to their existing debt covenants, engaging in a discussion with their bankers, and possibly renegotiating loans, and ensuring that discussion happens with their bond agents.

Transition (Continued)

• They should be examining the terms of all of their lease agreements, including those with related parties. If, for example, they decide to change a related party operating lease for a building to twelve months or less, they will have to analyze the impact of any leasehold improvements to that building they may have recorded on the books.
Transition (Continued)

• What is the economic life of a leasehold improvement if the lease is twelve months or less? Will the remaining balance need to be amortized in the year of change? Most likely, it should.

Why Do We Care?

• Top Reasons:
1. Negative effects on the balance sheet and P&L of most companies due to capitalization
   a) Working capital calculations impacted by current portion of lease obligations
   b) Debt load increase possibly precluding additional borrowings
   c) Net income decrease resulting from front-end loading (interest and amortization)
Why Do We Care? (Continued)

• **Top Reasons (Continued):**

  2. Debt covenant violations due to effects on ratios as a result of above

  3. Bonding Company issues (Working Capital, Debt, Equity & Ratios)

  4. Comprehension of the issues (implementation will be difficult)

  5. Evaluation of lease vs. buy significantly increased/Renegotiation of leases

Why Do We Care? (Continued)

• **Top Reasons (Continued):**

  6. Cost of compliance - Expect increases in accounting fees required to audit new leases and/or to assist in calculations

  7. Little to no return on investment in this work.

  8. Think not about 2 years out, but today as all decisions affect future implementation.
Conclusion

Companies should use the time now—well before the date the standard needs to be adopted—to take a measured approach to addressing the standard’s potential impact.

Credits

- The majority of this presentation comes from an article to be published in the Fall, 2019 issue of the Surety Bond Quarterly, “People Get Ready, There’s A Change A-Coming – The New Lease Accounting Standard”
  – Authors – R.A. Bobbi Hayes, Larry May, and Robert Coker, Carr, Riggs & Ingram, LLC