KS ADVISOR BLOG

Changes to Lease Accounting

By Trever Campbell, *Partner*
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If you are a business owner, CFO, lender, or investor, you have probably long heard rumors of a new lease standard coming in the world of accounting. In fact, you have probably heard about it for so long that you don't even remember when or what it is all about at this point. Well, the "when" is finally now, and the "what" I will describe more for you here.

Changes to the way leases are accounted for have been talked about and in development for well over a decade. In 2016 the Financial Accounting Standards Board (FASB) finally issued new lease guidance with Accounting Standards Update (ASU) 2016-02… and yes that is almost eight years ago now. Following that initial pronouncement there were amendments, then delays, then more delays, then more amendments. In fact, since the first ASU in 2016 there have been FIVE additional ASUs released related to leases with refinements and updated target dates, and even now there are more proposed tweaks currently under review. So, if you have lost track of the current status don't stress, we are here to help.

Here's what you need to know now:

- **When is it?** Technically, the standard is in effect as of January 1, 2022. Practically, that means that most of us will see the impacts for the first time on the financial statements issued in early 2023. While public business entities reporting under accounting principles generally accepted in the United States (GAAP) and businesses that report under internal financial reporting standards (IFRS) have already been complying with this standard for a couple of years, this is now the year where it finally will also impact private companies, which is who most of us work for and with.

- **What does it mean?** In the simplest terms, it means that all leases will now appear on the balance sheet regardless of their size or structure. In the past, leases had two classifications: Capital and Operating. Capital leases were generally longer term, high value leases, whereas operating leases were shorter term, lower value. Capital leases went on the balance sheet, and operating leases were simply recorded through rent expense.

  Going forward, all leases will be on the balance sheet whether they are Financing (new terminology, but similar to Capital) or Operating. While there is a lot of nuances, the main thing to know is that every lease will appear as a "Right To Use Asset" and a "Contract Liability" in some form of parlance on the financial statements.

  At first glance it is difficult to comprehend what that will mean, so let me give you a basic example that will impact many companies. If you operate a business, chances are you lease or rent a building. In the past, it is very likely you accounted for that building as simple rent expense when you paid it each month. The building itself never showed up on the financial statements other than as a footnote disclosure perhaps. Going forward, that building will now be represented as both an asset and a liability which will have to be calculated and recorded on the balance sheet. The liability will represent the future payments you are contractually obligated to make, the asset will represent your contractual "right to use" that space in the future. Depending on the length of your lease agreement and the value of the property, this could mean that you will suddenly have millions of dollars of assets and liabilities appearing this year.

- **How will it affect me?** The main impact this is going to have for most is on historical financial ratios and loan covenants. At the outset, the asset and liability will be mostly in-line with each other (although this will skew over time as payments are made and the asset is amortized). Even if it was a direct 1:1 relationship though, it will still affect liquidity ratios like the current and quick ratios where the numerator and denominator are not at 1:1 already. Leverage ratios like debt to cash flows may have to be adjusted to account for the new contract liability, unless the language already exempts those type of liabilities, as will debt service coverage ratios.

So what should you do? If you are a business owner, get in contact with your CPA and start gathering all of the lease contracts and arrangements you need to have evaluated. Most CPAs, like Kernutt Stokes, have invested in software that can make calculating, updating, and disclosing leases much easier than trying to do it on your own. Also, it will be much easier to get everything in order prior to year-end than to try and make the adjustments retroactively in March and April when your financial statements are being prepared. If you are a lender, start looking at your loan agreements and see if the ratios and covenant language may need modification. Be proactive and reach out to business owners to find out what kind of adjustments they have made or are expecting to make, and if they are not sure yet, nudge them to reach out to a CPA for assistance.

Regardless of whether you feel ready or unprepared, this change is finally here so now is the time to act on it.