

New Lease Accounting Standard's Impact on Operating Leases

Written by Jason Borofsky, CPA, MBA
Senior Manager at Sax LLP

The Financial Accounting Standards Board (FASB) has issued a new lease accounting standard, ASC 842, intended to improve financial reporting about leasing transactions. The new standard will have a significant effect on how operating leases are presented on the lessee's balance sheet and the notes to the financial statements. Changes will go into effect for fiscal years beginning after December 15, 2018 (public companies), and December 15, 2019 (private companies). While this may appear to present a cushion of time, public companies are required to present 2 years of the balance sheet (2018-2019) and 3 years of profit and losses on their financial statements (2017-2019). Early adoption of this standard is also permitted. With that, both lessees and lessors need to evaluate and address how the significant changes will impact them now and moving forward.

How will the financial statements of the lessee be different?

Currently, the future minimum lease payments for operating leases are disclosed in the notes to the financial statement only. Under the new lease standard, operating leases are now required to be reported on the balance sheet as a right-of-use asset and a corresponding liability. The right-of-use asset not only includes the initial term of the lease, but also requires the lessee to evaluate the likelihood of exercising the renewal options of the lease. If it is likely the lessee will exercise the renewal option, it must be included in the right-of-use asset and corresponding liability. In addition, the lessee must include a narrative disclosure of the options recognized and not recognized as part of the right-of-use asset.

How will this effect loan covenants and financial ratios?

It is expected by the FASB that the new lease accounting standard will not have a significant effect on the loan covenants, such as the debt service coverage ratios and other liquidity ratios. The new lease liabilities should be considered by banks as an operating liability and not to be included as additional debt. On the profit and loss statement, the lease cost (interest and amortization expense) of the operating leases is still going to be included in the operating expenses as one single "lease cost" line item. There have been efforts by banks to update the definition of assets included in the loan documents to consist of only "tangible assets". The right-of-use asset is an intangible asset and would be excluded from any such asset related calculation. Other options for updates to the loan documents by banks is to include a provision to freeze generally accepted accounting principles (GAAP) as of a certain date. Therefore, any changes made to GAAP in the future will not influence the loan covenants.

Since the return on assets calculation will be effected by the new lease accounting standard, a lessor will have to evaluate its key ratios utilized internally and determine whether adjustments are required in the evaluation process of a potential lessee.

It is imperative to evaluate how the new lease standard will impact your company. Be sure to enlist an experienced advisor to appropriately inform you on the effects of the new standard and properly guide you on evaluating business processes, internal controls and financial statements prior to the implementation of the new standard.

For any questions or issues regarding the new lease accounting standard, or anything real estate related, please feel free to reach out to Jason Borofsky at JBorofsky@saxllp.com.