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The Unseen Complexities of Lease Accounting

Lease accounting is the process of evaluating, classifying, recording, and reporting lease transactions in your financial statements. It ensures that leases are properly accounted for on both the income statement and balance sheet..

In recent years, ASC 842 has introduced new standards for lease accounting, significantly changing how leases are recorded. These changes have added complexity, requiring businesses to recognize most leases on their balance sheets, impacting financial ratios, and increasing the need for detailed disclosures.

In this document, we'll explore some of the complexities of lease accounting and highlight the critical role of an experienced CPA in navigating these challenges and optimizing your financial performance.

What is ASC 842, and why does it matter?

Lease accounting under Generally Accepted Accounting Principles differs from how you report lease payments on your tax returns. If you need to provide financial statements to banks, investors, or other third parties, you must adhere to ASC 842 and recognize leases on your balance sheet. This helps present a clear picture of your financial health and obligations.

The Financial Accounting Standards Board established ASC 842, a standard that governs how you record the financial impact of lease agreements, to ensure consistency and accuracy of financial statements. At a high level, ASC 842 requires businesses to recognize most leases as assets and liabilities on the balance sheet. While this seems straightforward, it's not always so simple in practice. And it's essential to get it right because lease accounting can impact key financial ratios, influencing your company's creditworthiness and investment appeal.

How is a lease defined?

A lease is a contract that gives you control of an asset for a specific period in exchange for payment. However, the contract doesn't need to specifically say that it is a lease.

For example, a monthly fee for a dedicated server could potentially be considered a lease, even if it's referred to as a service agreement.

Complicating matters further, some contracts may contain both lease and non-lease components. For instance, you might sign a lease for office printers that also includes IT support and maintenance. The lease component would be the equipment, and the non-lease component would be the IT support. Separating these components and applying the appropriate accounting treatment can be time-consuming and is often prone to errors.

Which leases must be recognized on the balance sheet?

There are two types of leases: finance leases and operating leases. A finance lease is similar to buying on credit, where you assume more of the risks and rewards of ownership and may eventually become the owner of the asset. An operating lease is more like renting, where you use the asset without the transfer of ownership.

Historically, only finance leases, which used to be called capital leases, were recorded as an asset and liability on the balance sheet. Because operating leases weren't recorded as assets and liabilities in the past, financial statements could be misleading, making companies appear as though they had stronger financials than if the lease was recorded on the balance sheet. To address this issue, ASC 842 now requires both types of leases to appear on the balance sheet as an asset and a liability.

However, determining which type of lease you have can be tricky. Factors like how long you'll use the asset and how much you'll pay over time compared to its fair value come into play. It's imperative to get this right because the expense recognition pattern differs for operating and finance leases. Operating lease expenses are spread evenly over the lease term, while finance leases require amortizing the asset over either the lease term or the useful life of the asset, whichever is longest.

A company's ratios are also impacted by the classification of the lease. Finance lease liabilities are considered debt and would impact leverage and debt-to-equity ratios. On the other hand, operating lease liabilities are not considered debt and would result

in more favorable debt ratios. Conversely, finance leases result in higher Earnings Before Interest Depreciation and Amortization than operating leases. Obviously, getting the right classification is important.

When do you start recording a lease?

Timing is crucial in knowing when to record a lease or make adjustments to your balance sheet.

You might think that the day you sign a new lease is when the accounting starts. But what if you don't use the asset right away? Or what if you make changes to an existing lease? These events, called triggering events, can affect how you account for the lease, and missing these can lead to errors and potential audit issues, so you must track and record them accurately.

You have to consider "reasonably certain renewal."

The way a lease is recorded on the balance sheet is dependent upon the projected term of the lease, which includes the current lease term and potential renewals. That said, figuring out whether you'll renew a lease is an important aspect of lease accounting. Accountants call this a "reasonably certain renewal," and it plays a key role in your financial projections.

But business situations and outlooks change constantly. For example, if your business is stable and you don't plan on making any large changes, you're most likely going to renew your lease. But if your business is struggling or, alternatively, doing so well that you might need a different space or equipment, renewal may not be so certain.

So, you must continually reassess how your business is doing and other factors that might contribute to a decision whether or not you'll renew your lease. In some cases, it may be necessary to adjust your projections if circumstances change.

Modifications and re-measurements are complex.

Lease modifications, such as changes in scope, term, or payment, can impact your accounting, requiring you to recalculate your assets and liabilities. This process can be complicated, and errors can cause significant issues.

Understand impairment

When you record a leased property as an asset, its value might decrease due to economic downturns, market changes, or unforeseen events. If the asset's fair market value falls below its carrying value on your balance sheet, this is called impairment.

Some indicators of impairment include a significant drop in market rents, changes in how the asset will be used, poor operating performance, or plans to sublease or exit the lease.

If these indicators are present, you must test the asset's recoverable value. If the recoverable value is lower than the carrying value, you must record an impairment equal to the difference.

For example, let's say you lease a warehouse with a carrying asset value of $4 million. Due to a downsizing, the recoverable value of the asset is reassessed at $2.8 million. You would record a $1.2 million impairment loss, which is the difference between the carrying value and the recoverable value.

This impairment loss is expensed on the income statement and reduces the asset on the balance sheet, but the lease liability remains unchanged, as your company is still obligated to make the remaining lease payments.

Impairment testing involves sophisticated calculations and judgments. Determining the asset's fair value and recoverable value requires careful analysis and specialized expertise. It will also change your amortization pattern, affecting your future financial reporting.

Lease accounting is more than just numbers.

It's important to consult a CPA before entering a lease and prior to any renewals or adjustments. A knowledgeable CPA can ensure your financial reporting is accurate but more importantly, can help you identify opportunities to minimize financial impacts to ratios and debt covenants, optimize lease terms, reduce costs, and mitigate risks.

Partner with a CPA experienced in lease accounting

The complexities inherent in lease accounting are undeniable. From lease classification and impairment to the intricacies of modifications and renewals, it’s imperative to work with a CPA who has specialized knowledge in this area.

An experienced CPA can offer the financial insight needed to streamline lease management, ensure compliance with ASC 842, and optimize your lease portfolio for maximum financial performance.

Next Step

This overview only scratches the surface of lease accounting. Each lease agreement presents its own unique challenges and complexities. For assistance in properly accounting for your leases on your balance sheet, please contact one of our expert advisors.

About Heard, McElroy & Vestal

In 1946, S. Berton Heard, Charles McElroy and Charles Vestal founded Heard, McElroy & Vestal, LLC in Shreveport, Louisiana. Together, this trio of professionals established the firm as a pillar of trust, integrity and competence, with the mission to create solutions and provide opportunities for our clients, our people, and our communities. HMV is one of the largest public accounting and consulting firms in Northwest Louisiana, servicing our clients throughout the states of Louisiana, Arkansas, Texas, Mississippi, Oklahoma and Tennessee from offices in Shreveport and Monroe. Our firm is comprised of over one hundred (100) employees: Partners, Of Counsel Partners, Senior Managers, Managers, additional Professional Staff and Administrative Staff. Our Professional Staff includes more than fifty (50) certified public accountants who obtain additional certifications which are Accredited in Business Valuation (ABV), Certified Fraud Examiners (CFE), Not-for-Profit Certificate holders, Certified Valuation Analysts (CVA), Personal Financial Specialists (PFS), and Certified Mineral Managers (CMM). Our team of professionals brings together many years and diversification of experience, providing a network of knowledge and resources and allowing for industry and niche specialization. Not one CPA can offer the range and quality of services a firm of our size is able to provide, while remaining small enough to deliver personalized service and attention to our clients with consistency on engagements. HMV's strategic associations include Aliign Mineral Management, LLC, Business Valuation Consultants, LLC and HMV Wealth Advisors, LLC.

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