Making the Transition to New Accounting Standards

Now is the time to ensure your compliance with FASB Topic 842

MAJOR ISSUES ADDRESSED IN THIS YARDI REPORT

- The nature of the accounting changes
- What lessees need to know about leasing under new rules of engagement
- The impact on taxes and internal reporting structures
- Practical expedients in the new reporting environment
- Automating processes to ensure consistency, flexibility and accuracy

Your balance sheet is about to get a makeover. The Financial Accounting Standards Board (FASB) has long served as an overseer of reporting transparency. For that purpose, the board has implemented rules to push all leases, be they operating leases or rentals, onto your balance sheet.

What is now known as Topic 842 – also known as ASC (or Accounting Standards Codification) 842 – has been in the pipeline for several years now under the formal title ASU 2016-02. On the global front, the new standard is IFRS (or International Financial Reporting Standards) 16. The original FASB standard called for compliance as far back as 2019. But the updated standard's adoption has been pushed back several times, originally in recognition of the complex nature of the transition, and then on account of the disruptions of COVID-19.

Those delays are now at an end. As the Journal of Accountancy **reported** in November 2021: "The current effective date for nonpublic entities is for fiscal years beginning after Dec. 15, 2021, and interim periods within fiscal years beginning after Dec. 15, 2022." During the same meeting when the FASB board set the effective dates, it also decided that no further deferrals would be granted.

CREDITWORTHINESS UNDER GAAP

What does compliance mean and what are the penalties? Although no monetary sanctions apply, non-compliance does put firms on the wrong side of Generally Accepted Accounting Principles (GAAP), which can have a serious impact on creditworthiness.

"In order for financial statements to be in accordance with GAAP, companies need to follow the guidance of Topic 842 and adopt the guidance in accordance with the effective date," states Claudia Bassett, CPA, a Los Angeles-based director in CohnReznick's assurance practice. She explains that bank covenants, as well as investors and other stakeholders, may require financial statements to be filed in accordance with GAAP. To be out of compliance with the latter renders a firm out of favor with the former.

Ian Marlow breaks it down further: "If I have a four-year lease, I'm going to have to present the entire value of the remaining obligation of that lease as a liability on the balance sheet," says the CEO of Boca Raton, Florida.-based FitechGelb, a consulting firm specializing in technological solutions. "That's a significant change that obviously could affect someone's creditworthiness when their balance sheet is being scrutinized.

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IAN MARLOW
FitechGelb

WHEN IS A LEASE NOT A LEASE?

Compliance first demands a strong handle on all leases. And in an interesting nuance, that includes agreements where the word "lease" may not even appear. In those cases, the documents known as embedded leases must also be folded into the balance sheet.

As Bassett notes, Topic 842 defines a lease as "conveying the right to control the use of the specified asset over a period in exchange for consideration, and it could be a portion of a contract." For instance, the balance sheet may also reflect agreements for telecom or IT services that include equipment as part of the overall deal. It could also pertain to office and construction equipment, vehicles and even charging stations. If the agreement fits the definition, the word "lease" may not even be used.

"You're paying a monthly fee to a service provider," Bassett says, "but that fee includes all of the hardware that you didn't purchase. Those are the considerations that companies have to assess as they gather up their contracts to determine whether or not they contain an embedded lease."

And that consideration piles on top of an already complex preparation time for corporations. Unfortunately, the complexity could come in large part from a lack of corporate diligence. "I've come across so many organizations, some with as many as 100-plus locations, without any clue as to where their leasing data is stored," says Sagar Morabia, Yardi's senior director of product management. Centralizing that previously uncollected data will be the biggest problem corporations will have in this process, he says.

The nuances of FASB's definition obviously extend far beyond the bailiwick of the corporate real estate department. Experts indicate that the compliance initiative is a partnership of multiple departments.

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Yardi Systems Inc.

But which departments would be involved depends on a company's internal structure. Functions such as finance, accounting, legal and tax are each likely to have a hand in ensuring the accuracy of the balance sheet.

And while the logical assumption is that accounting would take the lead and own Topic 842, "this isn't an exercise for the accounting department to do in a bubble," Bassett said. The key takeaway, she says, is that proper lease accounting calls for organization-wide communication.

Marlow calls it a "partnership and a human process as opposed to an internal process." Since outside providers may be involved, tax considerations are not necessarily internal. This collaborative effort is just one reason why the complexity of compliance has delayed implementation for so long. "You need the process of adoption to be in place for the report to generate the right information," Marlow said. "Your operations need to become a well-oiled machine."

The tax question brings up a misplaced concern often voiced by FitechGelb clients, many of whom assume that 842 will impact how leases are treated for federal income tax. "Not true. It affects only what you're doing in terms of your balance sheet," says Marlow. But he is quick to warn people not to take compliance lightly for that reason; creditworthiness is reason enough.

Marlow also makes it clear that the new reporting system is just that and only that, "no matter who prepares it," he explains. "It won't change the lease transaction process."

It might, however, change the wording of leases, especially as related to embedded leases. "There may be some gentle language within a lease that might change," he says. But that call will be made on a case-by-case basis by the legal department.

More specifics are hard to come by since every contractual document in the commercial sector is unique. Unlike residential leases, Marlow observed, "every single commercial lease is different and every format is different, based on the culture and needs of that particular company."

EASING THE TRANSITION

Fortunately, a kind of relief valve is built into Topic 842 compliance. It comes in two kinds of practical expedients: transitional and ongoing.

Not surprisingly, the election of the practical expedients demands careful consideration, Bassett says. As the **CPA Journal notes**: "In ASC Topic 842, FASB provides entities relief from the burden of having to determine whether leases are included in existing or expired contracts at the transition date." It offers the examples of trucking companies and airlines, which might elect the transitional expedient due to the cost of reviewing all contracts to root out the lease components.

FASB also provides relief from reevaluating existing lease classifications. "A capital lease under ASC Topic 840 would not be significantly affected under the new guidance if it met the criteria for classification as a finance lease (i.e., the existing lease asset and liability would be renamed during transition)."

In November 2021, Bassett and Matthew Derba, partner and national director of accounting at CohnReznick, addressed the practical expedient issue **during a webinar** hosted by Bisnow and presented by Yardi.

Bassett indicated that the transitional expedients (referred to as "package of practical expedients" that must be elected as a package) provide:

1. The election to not reassess existing and certain expired contracts to determine if they are leases or have one embedded in the wording;
2. The election to not reassess a lease classification (as Bassett explains, "the company may maintain the same original lease classification as under Topic 840"); and
3. The election to not reassess initial direct costs, especially since fewer costs qualify under Topic 842 (this would occur "as there are fewer costs that would qualify to be capitalized than under Topic 840," she said).

In short, ongoing expedients allow for a short-term exemption, Morabia explains. "An equipment lease might be less than 12 months," he says. "If so, you can exclude it from all calculations."

Bassett points to FASB's own wording:

- "As a practical expedient, a lessee may … choose not to separate non-lease components from lease components and instead account for each … as a single lease component."
- "Leases that are not public business entities are permitted to use a practical expedient that allows them to make an accounting policy election to use a risk-free rate as the discount rate by class of underlying asset."

BETTER REPORTING THROUGH TECHNOLOGY

The sheer complexity of transitioning to the new FASB standard will require companies to think carefully about the tools that are available to track their leases. “Whatever a company decides in terms of accounting for its leases, it’s imperative that management determine the best course of action,” says Bassett. This is true not only for the transition but for the long-term application, given the volume of data, the calculations involved and the impact these will have on all assets within a portfolio.

She sees a two-fold benefit to automation: first is to provide management the capability to continuously account for leased assets and lease liability. Second is to help “mitigate risk of formula errors and make the process of tracking changes easier, such as lease modifications or new leases.”

Geoffrey Gelb, president and cofounder of FitechGelb, agrees. “Now that there’s an adopted standard, software companies are creating a compliant and easy-to-use tool for this new rule to be appropriately accounted for and reported on.”

Keep in mind that the software product and the service that backs it up are two different considerations. As with the new accounting standards, shopping for the right vendor calls for doing the necessary homework. “No matter what application you choose,” says Morabia, “the resources and stability to back it up are essential.” Signing with a startup that might lack adequate bandwidth or financial backing will only further complicate already complex matters.

“The key takeaway is that there should be communication throughout an organization to properly account for leases.”

CLAUDIA BASSETT
CohnReznick

With that box checked, Morabia points to the consistency and flexibility a robust application, such as Yardi Corom, can provide. “Adopting and maintaining these guidelines is not only complex, it’s also not your core business,” he says. To that end, flexibility and consistency are key to minimizing compliance headaches.

He provides the example of a commercial lease for which a lessee is trying to calculate present value of future lease payments—as noted, a key component of the FASB guidelines. “They can click a box to indicate if it is a finance or operating lease if they already know,” he said. Otherwise, they can answer a series of questions that allow the application to help classify the lease.

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GEOFFREY GELB
FitechGelb

The system can also aid in scenario modeling; for instance, comparing different transition dates to new guidelines to gauge the potential impact on the balance sheet.

There is no denying that bringing a hodgepodge of leases into compliance with the new standards is a tricky and complex operation, demanding the resources of many different disciplines within (and possibly outside) your organization. It also calls for tools that are up to the challenge.

But as Claudia Bassett points out, one thing is clear: “now is the time to start planning and adopting the new guidance.”

Contact us to discuss the Yardi Corom solution.

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