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The New Lease Accounting Standard What You Need to Know | Video Transcript

Kat Jenkins:

Hi, and welcome to Barnes Dennig Ask the Experts. I'm Marketing Director Kat Jenkins, and today we're talking about the new lease standard. It's a hot topic. It goes into effect for most private entities on January 1st, 2022, and today assurance industry thought leaders, Tom Groskopf, and Matt Rosen are going to unpack some of the key issues surrounding the lease standard, as well as what you need to do to be ready. Please join me in welcoming Tom and Matt.

Matt Rosen:

Thank you. So Tom, from talking with companies, most companies by now know a couple of things relative to the lease standard. One, they know it's effective in 2022 for calendar year-end for private companies. And in two, they understand the highlight that operating leases, which were previously just disclosed are now on the balance sheet as an asset and a lease liability. They also note, they may not have reporting requirements until the end of 2022. So they think they have time to implement this standard. So the questions today revolve around why there may not be as much time as you think, and how being proactive and starting early on this implementation can really pay off for an organization. So to jump right into the first question is what are some of the changes, the highlights to the financial statement that users will see and really need to be made aware of proactively?

Tom Groskopf:

Sure, Matt. And thank you to Kat for setting this up and allowing us to have this opportunity to speak to our virtual audience. Well, I think, first of all, Matt, the recognition that on January 1st, 2022, a material journal entry will be made affecting assets and liabilities for substantially all private companies. Since substantially, all of them have operating leases and in most cases, that's going to be a material journal entry. And I think what some of the current adopters, be it public companies or other private companies that have chosen the early adopter have found is that they ended up putting more on their balance sheets than they originally anticipated. According to surveys that we've done and we've seen, 60% found additional operating leases that needed to be recognized on the balance sheet as of 11/22 that were not previously being disclosed in prior financial statements as operating leases. So those are the types of surprises that you want to try to manage sooner rather than later so that unpleasant consequences don't emanate from these surprises.

Matt Rosen:

I know it can be a very complex standard to get to identifying what some of those impacts will be to those financial statement users. And as you've gone through this with companies, what are really some of the top one or two issues that they really struggle with in implementing the standard, that may be unexpected?

Tom Groskopf:

Well, I think the biggest challenge is getting out of the gate. So first of all, you've got to be motivated to get out of the gate, and assuming you're motivated to get out of the gate, you find that the ground is rather treacherous there at the beginning. The first thing that you need to do is get a handle on all of your vendor contracts and examine those vendor contracts to see if the provisions give you a right to control a piece of identified property, which is a technical determination for whether a lease exists. And that goes beyond more than just, it says, lease at the top of the document. You need to look and read the document to see whether or not it meets the technical requirements to be presented as a lease. And many companies have found that what they had historically felt were leases and disclosed as leases was insufficient to comply with the definition of a lease under the new lease standard.

Matt Rosen:

Clearly, the complexity means being proactive to just get out of the gate and understand the impacts. But there is a strategic aspect to this, and for years, private companies that were proactive, or public companies as well have structured their leases to get a desired impact, whether they wanted it on the balance sheet or an operating lease. And where are some of those opportunities to really benefit from, whether it's structuring, or renegotiating their leases to get a more favorable impact?

Tom Groskopf:

Sure, Matt, great question. And I think everybody's familiar with the structuring of leases, such that the present value of the future minimum lease payments are 89.5% of the fair value of the underlying asset or other gamesmanship that went on with termination penalties and things of the like. Contract management approach to avoid recognition of operating leases on the balance sheets really circles on the definition of a lease and whether or not what you sign in a contract is or contains a lease. And so it's going to be a more sophisticated process in many respects because the straight mathematical calculation will not be there. You're going to need to read those documents to see whether or not it gives you the right to control a piece of identified property. Now, if you can achieve the same commercial objective by perhaps contracting for an output, as opposed to contracting for control of an identified piece of property, plant, equipment, then you may find that you're going to get the accounting result that you may desire.

For example, in the standard, there's two different examples where in one case, an entity contracts for use of servers, and those servers are leases. And in the other example, they instead contract for a certain amount of network services at a desired speed, and it's up to the vendor to meet the desired output. And in that case, it's not a lease. So, you see some of the fine distinctions that are based on whether or not you have a right to control a piece of identified property, plant equipment, or conversely, you don't have control of a piece of identified property, plant, equipment, but you're contracting for an output.

Now you don't really even get to any of these fine distinctions and being able to manage to a particular financial reporting outcome that you're looking for. If you don't first gather all the contracts, centralize the contract management, and then lastly read the contracts so that you know where your potential areas to renegotiate in the future are. Second, for any new contracts that you may be entering into in the future, where you might be able to structure them a bit differently to get a different financial reporting outcome.

Matt Rosen:

Can't underestimate the complexity here and the opportunity that's available to those who are proactive in this. And, once you sign those leases, the accounting treatment is going to be dictated. So, if we can understand the standard and get ahead of the game and negotiate those leases in advance, we can definitely get more desirable, beneficial accounting impacts. So again, thank you, Tom. I think we both agree that it's never too soon to begin this implementation process and start to understand its impact. And if you'd like more information or would like to set up a conversation, visit the Barnes Dennig website, contact Tom or myself, and we'll see you next time on the Ask the Experts.