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Accounting standard change will impact how private companies report real estate, other leases

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Over the past two years, many private companies' finance departments have been busy accounting for Paycheck Protection Program funding amid the pandemic.

This year, these companies — and their accounting firms — will be busy addressing a new challenge: compliance with new Financial Accounting Standards Board (FASB) leasing guidance that requires, for the first time, all private companies to recognize operating lease assets and liabilities on their balance sheets.

The new lease standard is designed to create greater transparency around company financials, said **Michael Sabol, partner at Glastonbury-based accounting firm Mahoney Sabol & Co.** Under the previous standard, only capital leases were required to be listed on a company's balance sheet, while operating leases were mentioned in footnotes.

For accounting purposes, a capital lease is similar to owning an asset, even if it's being rented for a period of time, while an operating lease is more like renting a property.

The change is part of a broader, multiyear evolution of standards to bring the country's generally accepted accounting principles, or GAAP, more in line with international accounting standards.

Public companies were required to comply with the new lease standards in 2020. Effective Dec. 15, 2021, the change now applies to all private companies. While the change is not yet required for quarterly financial statements, private companies' balance sheets must comply by the end of 2022. Original leases of less than 12 months do not apply.

"If [a company] takes a loan to purchase a printer and repays it at $1,000 a month and [another company] leases the printer for $1,000 a month, they have the same liability for the asset," Sabol said.

Under the old rules, however, only the first company would have shown that expense on its balance sheet; now, both are treated equally.

"It has no effect on the company's economics because they're still paying a certain amount for leasing the asset," he said. "But it's going to have a big impact on companies' financial statements."

For many companies, that increase in liabilities could impact bank covenants and loan agreements, which factor into a company's debt-to-equity ratios in setting terms. Companies may be in violation of their covenants depending on how debt is defined in the loan document, but the FASB allows operating leases to be characterized as "operating liabilities" rather than debt.

"This change can have significant ramifications for a company's loan documents, so it's good for clients to have a conversation with their bank early," said **Don Bidwell, manager of financial accounting and advisory services for accounting firm Marcum LLP**, which has offices in Hartford and New Haven.

An early start to this process is important, said Bidwell, because identifying all operating leases that need to be accounted for can be a challenge.

"People generally think of the office space or piece of equipment they're leasing," Bidwell said. "But there might be something in a service contract that could be considered a lease."

Tim Kolber, managing director of accounting advisory and transformational services at Deloitte, said the new standard impacts all facets of an organization.

"It's not just [an impact] from a finance perspective," Kolber said. "People from legal and procurement or anyone who could possibly touch a lease agreement should [be part of the process]."

More companies, as a result, are turning to technology, with nearly 40% of businesses using artificial intelligence and machine learning to comply with the standard, according to a recent survey from global human resources firm Robert Half. A similar percentage (41%) expect to rely more heavily on advanced technologies in future years, the survey found.

With the clock ticking toward the Dec. 31 deadline, Kolber said companies looking to implement technologies should start soon.

"It's not as simple as setting up a home accounting software," he said, noting that between selection, installation and testing of technology it could be a three- to five-month process.

This change also comes at a time when many companies evaluate their office space needs amid a remote or hybrid workforce.

The International Accounting Standards Board estimates that adding real estate leases — for both public and private American companies combined — under this new standard could collectively add nearly $3 trillion worth of liabilities on balance sheets.

That may drive some companies to adjust existing leases or sign shorter-term leases moving forward.

Sabol, of Mahoney Sabol & Co., said understanding what constitutes a real estate lease is also changing. He points, as an example, to a hospital affiliation, where one hospital might have space available in another to do work.

“Under certain circumstances under the new standard that could be considered a [reportable] lease now,” he said.

Bidwell, of Marcum, said he’s seen a steady increase in the number of clients who are starting to focus on preparing to meet the new lease accounting standard.

“It’s always easier to do sooner than later,” Bidwell said.