New Lease Standards Under ASC 842

Michael Novogradac, CPA, and Novogradac partner Frank Buss, CPA, help listeners answer three key questions regarding the new lease guidance, ASC 842: 1. What are the new operating lease accounting requirements? 2. How will the new standard affect various tax credit property partnerships? 3. What do you need to know about complying with the new lease guidance?

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Transcript

[00:00:10] **Michael Novogradac, CPA:** Hello. I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the June 21st, 2022, podcast. In this week's podcast, we're going to discuss some recent changes to the book accounting treatment for certain types of leases. When I say book accounting treatment, I mean, how certain types of leases are accounted for under generally accepted accounting principles or GAAP.

This may sound like a topic only your controller or accounting department needs to be aware of, but in a moment, I'll explain why senior management, project managers, investors, lenders, and many others also need to be aware of the recent changes. But first let me set the stage. The two most common types of leases are operating leases and what used to be called capital leases, but are now referred to more commonly as financing leases. As a general rule of thumb, capital or financing leases are leases where substantially all the risk and rewards of ownership of an asset are transferred to the lessee.

In this situation, GAAP guidance has generally provided that the lessee books both on asset and liability for the lease asset and obligation. The lease guidance we are discussing here today doesn't materially alter those rules.

Now the other common type of lease is what is referred to as an operating lease, which was, prior to the guidance we're discussing today, was a form of off-balance sheet financing wherein a company had a lease liability, but simply recorded annual lease expense on its income statement and did not record a lease liability or asset on its balance sheet.

Now, this podcast is about the recent changes to accounting for operating leases and how that liability is now reported on the balance sheet. The recent changes to accounting for operating leases follow many years where the Financial Accounting Standards Board or FASB and the International Accounting Standards Board have been working to improve the financial reporting standards for leasing activities. Those efforts led back in 2016 to FASB releasing Accounting Standards Update No. 2016-02, which provided updated lease accounting guidance. That guidance, ASU 2016-02, was codified as ASC 842.

The goal of the update is to increase lease accounting transparency, and comparability among organizations. The update sought to achieve that by requiring lease assets and lease liabilities to be recorded on the balance sheet and by disclosing key information about leasing transactions and financial statement footnotes.

Now, as I said, ASC 842 was released six years ago in 2016, but the implementation of the standard kept getting pushed back. The standard finally went into effect for fiscal years beginning after Dec. 15th, 2021, which means that a new guidance is applicable for calendar year 2022, which means now is the time to make sure your organizations know how to comply with the new lease guidance.

Today's podcast will help you answer three key questions regarding the new lease guidance. That is, ASC 842. Number one, what are the new operating lease accounting requirements? Number two, how will the new standard affect various tax credit property partnerships? We'll go into specific examples to address this. And number three, what do you need to know about complying with the new lease guidance?

But before we dive into that discussion, we'll discuss why you, the listener, should care about the new operating lease guidance contained ASC 842, even if you're not a CPA. First of all, the new lease standards may significantly alter your GAAP balance sheet. Those changes may affect your financial ratios and bank covenants. If that's the case, you may need to renegotiate terms with your lender sooner, rather than later. Another reason why you should care about the new lease standards is that making the necessary changes may involve a substantial amount of time and effort depending upon your situation and the nature of your business or businesses. For that reason, it's important to give yourself adequate time to prepare for any changes that need to be made. Additionally, there is transition guidance that may affect how your financial statements are presented during this implementation period. You'll want to understand the transition methods available and how they will affect your calculation of the least liability, the right of use asset and your financial statements.

Now, those are just a few of the reasons to pay close attention to today's podcast. Now joining me in today's podcast is my partner Frank Buss from our Dover, Ohio, office. Frank provides audit tax and consulting services to a broad spectrum of clients with a concentrated focus on projects and businesses receiving tax credit equity financing. As such, his expertise extends to renewable energy, low-income housing tax credits and new markets tax credits.

Frank will be able to share some examples of how the new lease standards affect developments in these various tax incentive areas. As you can tell, we have a lot to cover today. So if you're ready, as I say, every week, let's get started.

Frank, this is your first time on the podcast. Welcome to Tax Credit Tuesday.

[00:05:36] **Frank Buss, CPA** Mike, thanks for having me. I'm happy to be here.

ASC 842 Overview

[00:05:39] **Michael Novogradac, CPA:** So what should listeners know about the main changes to accounting for operating leases and the effective date of the guidance? Kind of expand on what I shared in the intro.

[00:05:51] **Frank Buss, CPA** Yes. Thank you, Mike. Yes, as you mentioned in the intro, so you're exactly right. The effective date is year 2022. So this is in effect right now. So we need to be worried about this implementation currently. The main change—and I went back and I looked the last update to the lease guidance that I found was like 1977, so that's about 45 years ago. It's been quite a while. So this is a significant change, across all the spectrum of the leases. And there's a lot of guidance out there, but I think the main item that we want to discuss and the main issue is how operating leases are accounted for under this ASC 842.

[00:06:37] **Michael Novogradac, CPA:** So let's talk about that ASC 842. Maybe you can talk a little about the debits and the credits, or, it's one thing for me to say in the intro that you have to book a liability and you book an asset, but then you have to unpack that. So if you could unpack how that calculation works and maybe to what extent might be different than how capital leases are accounted for, or finance leases are accounted for.

[00:07:00] **Frank Buss, CPA** Right. And as you said in the intro, too, Mike, previously operating leases were kind of an off-balance sheet item. It was just a footnote disclosure. It was off-balance sheet as far as the financial statements go. Now with this new standard, we're bringing a right-of-use asset onto the balance sheet, and that is calculated based on the present value of the lease payments over time.

So there's a present value calculation. There's a discount rate that needs to be applied. The guidance does allow for a practical expedient on the discount rate so that you can use a risk-free rate if you would like, if that's better for you or an easier method. And generally that would be like the U.S. Treasury rate or something equivalent to that.

So in year one you would essentially record this right-of-use asset and kind of an equal lease liability under your present value calculation. And then in year two, you would go forward, you would amortize your lease asset, right? And then your present value calculation would be changed every year based on your remaining payments due.

And that would also go into your lease amortization of that liability, to come up with your, current year lease expense and, and it would still be a lease expense, as it was before, it would be the same as that goes.

[00:08:32] **Michael Novogradac, CPA:** As before you would've the same annual lease expense, or you'd have the annual lease expense and then you would be kind of writing down your asset over time and obviously your liability would reduce over time. And is it true that the key change, key difference between that and a financing lease release?

One of the key changes is that within currently what's called an operating lease, you would just show operating lease expense every year. Whereas if the benefits and burdens or the risk and rewards essentially transferred, you recording as a financing lease, you would end up with an interest rate factor.

[00:09:07] **Frank Buss, CPA** That's right. That's right, same as in the past. If you had a capital lease, which is now a financing lease, as you mentioned there's actually an interest expense component to those, where with an operating lease and even with the new guidance there's no interest expense component with that. It’s still a lease expense is how it's classified.

Effects of the Guidance

[00:09:26] **Michael Novogradac, CPA:** Got it. Now let's shift gears to some of the effects it could have on project partnerships or businesses. Because I think of our typical client base, we have a number of project partnerships, and they have their own individual financial statements. Oftentimes obviously you have the general partners or developers that might be consolidating some of these entities into their own financial statements.

So there's a couple of levels where this could have both a direct effect on the lower tier property partnerships or businesses, as well as the entities that they might be consolidating into maybe a derived effect. So what are some of the reasons, or some of the concerns or some of the impacts that this is going to have?

[00:10:12] **Frank Buss, CPA** Sure and I think the biggest impact really to all those task credit entities potentially those entities that are consolidating them is we have a situation where we might be bringing a lot of liabilities onto the balance sheet that previously, were off balance sheet as we discussed.

So now that kind of changes the way the financials look in possibly a big way. That would be one significant impact. I would say another one and this is not financial statement related, but I think it's going take a lot of, depending on the entity and the business, it might take a lot of effort and a lot of time to kind of go through all these agreements and all these, sub entities and make this transition like that could be a very big time and effort requirement.

Debt Covenants

[00:11:07] **Michael Novogradac, CPA:** In terms of debt covenants, I mean, what are you hearing or having discussion with clients? What are some of the concerns that this could have with respect to the debt covenants?

[00:11:18] **Frank Buss, CPA** Sure. And as we kind of discussed, so we're bringing a lot more liabilities onto the balance sheet possibly. So, I'd say as you bring liabilities onto your financial statement, that's all unfavorable, as far as your debt covenants go. It would affect all those kind of negatively. Certainly your debt service coverage ratios, that would be affected negatively. Your debt-to-net-worth ratio, negative.

There's even some covenants out there where maybe you can't take on additional borrowings. And that could even, depending on how the banks look at that, maybe it would even trigger an issue with that kind of covenant as well. So we're seeing that, I think from a possibility going forward and, really, I think that it would be good to talk to your bankers now and your lenders now, and make sure that you are on the same page with them. And they understand that this change is coming. And just exactly how they are going to look at these different financial statements. And, it's not that anything with your business has really changed necessarily. Cash flows are still the same, but you know, these ratios have changed and, and it could trigger, some violations of your covenants So you would want to discuss those with your banker certainly.

Implications for Tax Credits

[00:12:33] **Michael Novogradac, CPA:** It seems like a couple of the critical steps are to identify which entities have additional liabilities you'll have to get booked, and then be sure to discuss with, and then to review your debt covenants with respect to loans with each of those entities and then form an initial view and then discuss with your lender.

What adjustments or amendments to the loan covenants might need to be made, but we can talk about that more, in a bit, in terms of some of the other things that we can go there. Before we get into that, let's actually talk about the various practice areas, unless there's anything else you wanted to share more generally.

So, when we think about this in the context of our typical client base and this is Tax Credit Tuesday, so about different types of projects being development, tax credits, and the possible effects. And it seems like when you're thinking about the effects of this, then you'd be thinking well, which practice areas involve leases more often than not? And the first thing you think about is renewable energy investment tax credits. So maybe you could discuss some of the effects you're saying with renewable energy investment tax credit or solar tax credit clients.

[00:13:51] **Frank Buss, CPA** Right. And as I look at our practice areas and the various task credits, I agree. I think that the renewable energy area and solar, I think that's probably the biggest impact that we would see here. And why I say that is because every deal that I've worked on, all of the financial statements and all of those, they almost always have a site lease or some kind of land lease. So they all have off-balance sheet financing generally.

For example, if we have a client that has maybe hundred projects and there's various sites in each project, there could be a lot of leases to go through. And that could be a very big impact on those financial statements and just not only on the financial statements, just the impact of, how do they get that, that task done and deliver their financial statements next March or April when those are due. That's going to be a heavy lift, I think, going forward.

[00:14:52] **Michael Novogradac, CPA:** And then if all those individual properties are now booking liabilities, then those liabilities could end up being booked on the developer's book. So they sent the developers consolidating.

[00:15:05] **Frank Buss, CPA** Well, that's a very, that's a very good point. And in fact, in that industry, most of the developers that we actually look at, they do consolidate those underlying entities. It’s going to be a huge impact to the consolidated financial statements of those entities.

And, it might be some surprises for, as we mentioned, the, the lenders and such.

[00:15:26] **Michael Novogradac, CPA:** The debt side of the balance sheet to go up and then the asset side will go up by amount. So there'll be a gross up of the financials. So the next area that, of course you see lots of leases are in historic tax credit transactions, where there's oftentimes some type of master-lease structure. And then obviously the tenants oftentimes have leases. What are your thoughts on historic tax credits? And, and maybe it's pretty much just the same as renewables.

[00:15:54] **Frank Buss, CPA** Yeah, no, I agree. I think it's pretty close to the same as renewables. I think you're right, Mike. I don't see a lot of big differences there. There's a lot of master leases, as you mentioned with historic tax credit transactions. So to the extent that those were maybe classified as operating leases prior, those would need to be looked at, and certainly you would have to adjust those going forward. But I would say it's pretty similar to the renewal energy tax credits, like you had mentioned.

[00:16:23] **Michael Novogradac, CPA:** So let's turn now to new markets. New markets, you're basically making an equity investment in a CDE, no leases there. And then the CDE-like development entity, oftentimes makes a loan, but could be making an equity investment, in a qualified business. So it seems like with new markets, it could be, at the qualified business level. What are your thoughts there?

[00:16:45] **Frank Buss, CPA** I think as you just hit it, really with the CDEs, investment funds, there would not really be an impact because I don't know that I've ever come across a transaction with a lease at that level. Maybe their sponsors have some leases possibly. But yeah, maybe at the qualified business level, certainly there could be long-term leases there. It could even be, say a copier lease or something of that nature that's long term or a car lease, potentially, something like that, that they would need to also look at this and make those adjustments accordingly.

[00:17:20] **Michael Novogradac, CPA:** Then since we're talking about new markets and community development, I would just note, and we don’t have time to go into all the details here. We probably could do a separate podcast on opportunity zones, and qualified opportunity zone businesses and the initial impact of these lease accounting rules on, qualified opportunities on businesses.

But we'll save that for maybe another podcast, but if you work in opportunity zones, you need to be sensitive to this guidance as well. The other major tax credit area, of course is low-income housing tax credits, which since most low-income housing tax credits you basically are building or renovating a property that you own and then you're leasing out to tenants. And you're generally speaking, not leasing, assets yourself, but you could be. So maybe you could discuss some of the areas where you're seeing this overlapping with low-income housing tax credits.

[00:18:10] **Frank Buss, CPA** Right. Kind of the same as like the qualified business and new markets. Like I mentioned, you could have certain leases at that level, maybe, car leases, different equipment leases of that nature. But, something I wanted to mention though, I think is, is maybe a big deal. In some parts of the country they use ground leases a lot. And I know that New York City, we have several clients in New York City and there's a lot of ground leases in those projects that are utilized. So to that extent, if your portfolios are kind of weighted in some of those areas, that that could be a big impact as well I think on your analysis there.

[00:18:50] **Michael Novogradac, CPA:** I do think it's important, as you mentioned, in terms of the types of leases that the partnership might be engaged, entering into as part of operating the property. But that's also a question as in, does the property partnership itself enter into that lease or does the party management company enter the lease and then pass it through?

So there's definitely some nuances there. And I wish we could spend more time in each of these transfer areas. Cause we probably go through and do separate podcasts on each one and all the different nooks and crannies that this lease accounting rule could creep in.

[00:19:26] **Frank Buss, CPA** Oh, yeah.

Action Items

[00:19:26] **Michael Novogradac, CPA:** But that's obviously some what you've been doing. So maybe you could, for listeners who are operating into these areas or, just in general, have businesses with leases, what are some of the actions that you're recommending that they take, to comply with the new standards?

[00:19:43] **Frank Buss, CPA** Sure. Sure. Well, well first, they can, certainly they should call us first to help them with this process. Right? Cause we're the experts in so they should, they should reach out to us. First of all, it could be a big effort, right? It could be a big effort for businesses and companies and tax credit entities in a big, heavy lift.

So I'd say start the process now. I mean, this is already in process. So we're already kind of behind it was effective 1/1/22. So start now, if you haven't started already. You have to go through your lease portfolio and identify your long-term operating leases. And, once you do that, and that's probably not an easy task, but once you do that, you have to go through the calculations that we talked about above, record your right-of-use assets, your lease liabilities.

And then as we noted you would have to make some certain entries right to get your accounting correct for the current year. So there's a lot to do. And I don't think we should delay too long on waiting because there's investor deadlines out there. Some are in February, some are in March.

And if we wait until then to kind of address this, we could be kind of upsetting some of those investors. If we're delayed on delivery.

[00:21:03] **Michael Novogradac, CPA:** The key here is you have to do all the calculations, then book the entries as of Jan. 1, 2022. Correct?

[00:21:09] **Frank Buss, CPA** That's right. That's exactly right. Because it started in Jan. 1, so we're already six months into the new standard,

[00:21:16] **Michael Novogradac, CPA:** And you said, one of the first steps is to identify all your long-term operating leases. Maybe you could clarify the definition of long term.

[00:21:25] **Frank Buss, CPA** Sure. Very good. So long term in the guidance is defined as a year or longer. So anything under a year really is kind of scoped out in a way. So it's really your year or longer leases that we're concerned with here.

[00:21:41] **Michael Novogradac, CPA:** I wanted to emphasize that point because a year doesn't seem like long term.

[00:21:47] **Frank Buss, CPA** Right.

[00:21:49] **Michael Novogradac, CPA:** But it's all your frame of reference. But when you're dealing with tax credits with, 5-, 7-, 15-year recapture periods, you don't think of one year as long term and there aren't too many assets like at least for less than a year. So as we're, thinking about kind of going through this process, are there particular challenges that we haven't discussed already in terms of how to go about making this assessment that you've described already?

[00:22:15] **Frank Buss, CPA** No, I think I really, Mike, I think we've touched on everything, I would just kind of reiterate just the big effort here and maybe it's even geared more towards, as we said, the renewable energy and some of their solar properties. And, and just to, get a jump on this now, before we get to the end of the year and, and, and then we get busy with everything else. And now's a good time if we haven't started this, to really get this moving.

Another item to consider too is there's some transition guidance in the accounting literature. So, that's something we can help with also. There's another acceptable method, with this transition impact that we can do and it's called the effective date method transition. So that would be where you do not restate your prior year financials, which is very less time consuming, very less effort. So that's a good outcome as far as time commitment. The only issue with that is you would have, if you're showing both years, say 2022 and 2021, it might not look comparative. You would have one financial statement one year under the old guidance and the current year under the new guidance. So you would have a mismatch there in the current year. But that would be your two possibilities. And we can help you with that too, on what that would take, to make those transitions, whether each method you choose.

[00:23:42] **Michael Novogradac, CPA:** Do you see any clients saying maybe I don't want to do GAAP financials anymore? I want to go to tax basis financials in all of this.

[00:23:58] **Frank Buss, CPA** I was going to say I don't. I don't see that all that often, but I'm surprised. I would think that that would be an option. But I also think that some of the investors want to see GAAP financials and that matters to them actually. So I am surprised we don't see more of those tax basis financial statements, yes.

FAQs

[00:24:18] **Michael Novogradac, CPA:** So maybe, it it'd be good for me to close with a question of questions. You might be thinking, what does it mean to close with a question of questions? So, what I mean is maybe you can just share with the listeners some of the questions you're getting by clients. And then obviously you can share briefly some of the answers to the questions that clients are giving you or asking you.

[00:24:42] **Frank Buss, CPA** Sure. Sure. Thanks, Mike. Very good. Yeah. So, so certainly how much time will this involve? That's a big question and I guess the answer would be, it depends, right? Depends on each tax credit portfolio and each client, I guess that would depend on how big the portfolio is and how many leases there are. So that depends.

What are the effects of my financial statements? And I think we kind of covered that fairly detailed already. That's another question. And then also something we covered is, will this delay the delivery of my financial statements because those investors are looking for those soon after year end. And again, I guess I would say that depends also if you kind of get a jump on this now we should be good and we would deliver those on time and should be squared away pretty well there. But yeah, those are, those are the main questions I would say we would get right now.

[00:25:41] **Michael Novogradac, CPA:** And then how about when we were preparing for this podcast, there was the question of are leases potentially embedded in other contracts where there's a contract that I don't think about having a lease in it, but does.

[00:25:55] **Frank Buss, CPA** Right. And that's a really good question because in the guidance there is some wording that if an existing contract or service contract or something of that nature has an embedded lease in it that you're required to actually record that lease. And that might catch a few people once they dig into those contracts that might catch a few people off guard where they didn't realize they had a lease there. And I've actually looked at a couple of those, some draft agreements on behalf of clients where they wanted to know, would this be determined under the standards? Would there be an embedded lease in here? And we've actually done some engagements like that, to help clients.

Exit

[00:26:39] **Michael Novogradac, CPA:** Great. Thanks for all that information. This is really helpful. Please do stick around, Frank, for our Off-Mike segment, where I get to ask you some fun questions not directly related to tax incentives. It might indirectly relate, and I will provide Frank's email address in the show notes today, so you can reach out to him.

But you could simply search for Frank Buss and Novogradac, and I'm sure you'll find him on the web.

To our listeners, please be sure to tune into next week's episode of Tax Credit Tuesday. My partner Lindsay Sutton will be on the podcast to discuss valuation hot topics with us. More specifically, we're going to discuss what low-income housing tax credit property owners should bear in mind when they're buying, selling or resyndicating properties amidst these current high inflationary times.

We don't know how much of the current inflation is transitory. Certainly some of it probably is, much of it may not be. If you develop or finance affordable rental housing, you're not going to miss next week's episode. As I say, every week, you can make sure that you're notified of that episode in each week's episode, by follow the subscribing to the Tax Credit Tuesday podcast, go to www.novoco.com/podcast to subscribe to and stream the show on our website.

You can also follow or subscribe to Tax Credit Tuesday on iTunes, Spotify, Google Podcast, Stitcher and Radio Public.

Off-Mike

Now I'm pleased to reach our Off-Mike section where listeners can get some off-topic advice and words of wisdom from our podcast guests. So Frank let's start with something. I am very much a person of routine.

I try to make habit my friend and I spend a lot of time trying to build good habits and spend efforts trying to break bad habits, but getting back to routine and what's a part of your daily routine that you most look forward to and why?

[00:28:36] **Frank Buss, CPA** So I don't know that it happens every single day, but I really look forward to getting outside, taking a walk, maybe walking the dog or not, but just getting outside and getting some fresh air and some exercise and every day. I think that really kind of clears your head and lets you appreciate kind being outdoors and in nature.

[00:29:00] **Michael Novogradac, CPA:** No. I agree with that. I think a walk every day is very good for your health, both physical and mental and emotional.

[00:29:10] **Frank Buss, CPA** I was going to say, yes, both physical and mental health, that's very good for you.

[00:29:14] **Michael Novogradac, CPA:** So everyone likes to talk about a favorite something to be a little bit more effective. So what's your favorite work or life hack or one of them?

[00:29:10] **Frank Buss, CPA** I don't know if this is as healthy as the outdoor walk, but I certainly enjoy a fresh cup of coffee in the morning. So start the day off with a fresh cup of coffee and maybe a few more during the day. And that even on the weekends, the coffee is a good way to start out and get things rolling. And maybe start things moving.

[00:29:47] **Michael Novogradac, CPA:** There are some positive health effects from that cup of java.

[00:29:51] **Frank Buss, CPA** I keep reading that there are actually some health benefits in there, so it's, yeah, it's helping my cause.

[00:29:59] **Michael Novogradac, CPA:** Whether that's true or not. You like it.

[00:30:02] **Frank Buss, CPA** Yes, yes, yes. We'll go with it.

[00:30:08] **Michael Novogradac, CPA:** So for the third and final question, this is something that I was like asking our podcast guests, what they enjoy most about their job or their career that they'd want to share with others.

[00:30:20] **Frank Buss, CPA** Great. Yeah. Great question. I would say the things I enjoy the most are working with great people like you, Mike, and working with all the other partners and all of our staff and working with all of our clients and just the interaction with everyone on a personal level and a personal basis.

And that I think is the best part of your job and just interacting with everyone and really achieving those goals that you have, your clients have and the firm has just on a personal level. I think that's a great thing about what we do and about our work.

[00:30:57] **Michael Novogradac, CPA:** It's definitely something that I really enjoy as well. And it's great to be able to make a living advancing affordable housing, community development, historic preservation, renewable energy and all the rest. It's a super sort of win-win-win. So I enjoy it as well.

[00:31:17] **Frank Buss, CPA** Absolutely.

[00:31:18] **Michael Novogradac, CPA:** Thank you again, Frank, and to our listeners. I'm Mike Novogradac. Thanks for listening.

Additional Resources

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