Smaller Bottom Lines for Those Who Lease

New rules will affect podiatrists in 2020.

BY JAMES D. KRICKETT

Whether equipment, other practice assets, or even the property housing the podiatric practice, lease and rental payments are frequently one of a practice's largest recurring expenses. Soon, however, those leases must be listed as liabilities on the balance sheet—suddenly visible to potential lenders, suppliers, and investors.

This is quite a change from the existing treatment where leases were considered "operating" leases with the rental payments simply deducted as operating expenses on the financial statements and tax returns. Although publicly-traded companies were required to begin treating leases as liabilities as of December 15, 2018, privately-held professional practices and businesses have until 2020 to comply—plenty of time to re-negotiate lease terms and plan to reap the potential benefits. Yes, benefits!

Accounting for Leases Before and After

The culmination of years of debate, the new lease standards are about whether and how liabilities associated with renting real estate, equipment, and vehicles should be recorded on the practice's books and financial statements. The new standard will require most practicing podiatrists to record leases on their practice's balance sheets.

Historically, accounting for leases has been straightforward: Determine whether it is a capital or an operating lease. For the latter, disclosure of operating lease amounts is considered a component of future commitments only, as these relationships are classified as "off-balance sheet." This off-balance sheet treatment has, however, long created a challenge for lenders and investors as they attempt to fully understand and evaluate a practice's financial obligations and future profit potential.

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In general, there are two methods for leasing: operating and capital leases. The vast majority of transactions are labeled as operating leases which, in the past, were treated like rental payments without the necessity of showing the the transaction on the balance sheet. In contrast, a capital lease is more like a loan, with the asset treated as being owned by the lessee, so it stays on the balance sheet.

Until now, only leases that led to

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the purchase of the asset were accounted for in this manner. Today, all leases with a term of more than 12-months must be present-valued and recorded on the podiatry practice's balance sheet as a "Right-of-Use" asset with a corresponding lease liability.

When a Lease Is a Lease

The new lease standard, Accounting Standards Codification Topic 842 (ASC 842, Leases), requires all professional practices and businesses to move the future costs of their operating leases from the balance sheet footnotes, where they are now reported, to the category of "liabilities." A corresponding "right-of-use" (RoU) asset gets recorded on the asset side.

In addition to changing how lessees will now be required to account for operating leases, the Financial Accounting Standards Board (FASB), the organization responsible for establishing accounting and financial reporting standards, also changed how leases are identified. According to the FASB, a lease is defined as a contract—or part of a contract—that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. In contrast, the ASC 842, new lease standard, defines a lease as an agreement conveying the right to use property, plant or equipment (land and/or depreciable assets) usually for a stated period of time.

While the definition of a lease appears substantially the same, ASC 842 significantly changes how leases are identified. Under ASC 842, a contract is, or contains, a lease if the customer (lessee) has the right to obtain substantially all of the economic benefits from use of the identified property, plant or equipment (PP&E) and the right to direct the use of the identified PP&E throughout the time that the identified PP&E will be used to fulfill the contract with the customer (lessee).

In other words, in addition to an identified asset, the practicing podiatrist, or his or her practice, must have the right to control the use of that asset which requires the economic criterion to be met. For example, under ASC 842, as long as the practice doesn't design something such as the solar panels installed on its building and doesn't operate or direct others to operate the solar panels, the arrangement won't be a lease—even though the podiatry practice has control over the physical access to the equipment and is obtaining more than a minor amount of the economic output of the equipment.

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A portion of an asset could be the subject of a lease, but only if that portion is physically distinct—such as a floor of a building, an office suite, etc. Under ASC 842, an arrangement giving the customer the right to 50% of the electricity from a solar panel array won't be a lease unless that right can be attributed to a physically distinct portion of the array.

Getting Onboard

The biggest impact from this change is, as mentioned, its effect on liabilities. The sudden spike in liabilities might trigger a loan or debt covenant and have creditors knocking on the podiatry practice's door. Fortunately, all of those liabilities will be offset by so-called RoU assets on the other side of the balance sheet. By adding more assets to the balance sheet, this new standard pushes the practice's "Return-on-Assets" (RoA) number lower without any fundamental change in practice operations.

With very few exceptions, all podiatric professionals are required to bring their practice's lease agreements on the balance sheet as a RoU asset and as a lease liability. The related expense will then hit the income statement under two headings—amortization of the "right-of-use" asset and interest accretion on the lease liability.

Probably the biggest concern for some podiatry professionals is the impact the new accounting treatment will have on certain balance-sheet ratios. Such an impact could be either beneficial or disadvantageous depending on the significance of different matrices to the practice entity. For example, applying the new standard may result in an increase in earnings before interest, tax, depreciation and amortization and operating cash flow, but will likely adversely impact the practice's liquidity and debt ratios.

Surprisingly, the new rules are predicted by many experts to have little or no impact on the income statement. In fact, according to the rule makers, there should be no effect on debt covenants. After all, the rules for classifying whether a new contract is a Capital (Finance) lease or an Operating lease are virtually the same as before under the Generally Accepted Accounting Procedures (GAAP) except that an Operating lease will now be a "Capitalized Operating" lease.

Although an Operating lease will now be capitalized, the capitalized asset cost by definition will be lower compared to a loan or cash purchase, resulting in a lower asset against which the Return on Assets (RoA) ratio would be measured. Even more complexities can arise from the fact that many lease agreements are silent on renewals although, in reality, the majority can be renewed.

The question of what period of a lease should be considered for accounting purposes under the new standards isn't provided by the voluminous new guidance. It can be argued that there is no valid contract beyond the initial lease term as technically both parties—the lessor and the lessee—can walk away from the lease after the initial term. Thus, the

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non-cancelable period is the contractual lease term and there is actually no "option" available to the lessee to extend beyond that.

If, however, the argument at the other end is that, in substance, the lessee and the lessor are reasonably certain to keep renewing the lease for at least a few terms and hence, the right-to-use asset should include the period for which such reasonable certainty exists. Obviously, how to determine this period will be a judgment call.

There are other, relatively "simpler" complications surrounding leases for property and other practice assets. The maintenance obligations of the lessor that are often included in a lease contract, is one of them. The new guidelines allow a podiatry practice to strip out any non-lease components and only account for the lease component of the RoU asset.

Stripping non-lease components from the lease agreement increases the accounting complexity. How to determine the value of these non-lease components where the lease agreement does not explicitly mention it will be a judgment call.

Many lessees also have variable lease payments such as revenue-based payments and inflation-linked rentals. The treatment of these transactions is fairly clear and will not usually require difficult decisions, although definitely adding time and cost when accounting for these transactions.

The Upside

While the new leasing standard will require somewhat different accounting procedures and reporting, the benefits of leasing remain, and are perhaps even improved. Combined with changes in the tax laws, lease financing, with its wide range of inherent advantages, will continue to be a beneficial option of for acquiring equipment and other needed practice or business property.

Passed at the end of 2017, the Tax Cuts and Jobs Act (TCJA) did include a provision that severely limited the current deductibility of interest expense to only 30% of earnings. Fortunately, many podiatry practices are exempt from this deduction ceiling.

A number of the TCJA's other provisions favorably impacted equipment acquisitions and financing. For example, leasing allows a practice unable to efficiently use 100% bonus depreciation to benefit from a reduced lease rate because the lessor can now claim the 100% write-off. Lessees may also reap an economic benefit simply by entering into sale-leaseback for an asset already fully expensed, since the gain would be taxed at the new favorable 21% tax rate for corporations.

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Sale Leasebacks

Sale leaseback transactions, or "leasebacks" as they are more commonly called, are transactions in which a practice sells an asset and leases it back for the long term. In other words, the podiatry practice continues to be able to use the asset but no longer owns it.

Among the advantage of leasebacks is that it enables the practice to realize cash from existing assets and equipment. The cash gained can be used for many purposes including acquiring another practice or simply providing extra working capital. The buyer, often the practice's principal or key employees, reap the many tax benefits of ownership of the property they lease back to the podiatry practice.

Under the new ASC 842 standard, a leaseback transaction would not be considered a sale if 1) it does not qualify as such under other accounting standards, or 2) the leaseback is actually a finance lease.

Transactions which include a fixed price purchase option will, as mentioned, no longer be considered a "successful" sale and leaseback. A failed sale-leaseback occurs when:

- Leaseback in classified as a finance lease, or
- A leaseback includes a re-purchase option that is at other than the asset's fair market value determined on the date the option is exercised.

This last item means any leaseback that includes a fixed price purchase option at the end will remain on the lessee's balance sheet at its full value where it will be classified as a fixed asset rather than as a Right of Use Asset. Even though an asset may have been legally sold, a sale is not reported and the asset is not removed from the lessee's balance sheet if these conditions exist.

The Economic Benefits of Leasing

With lease liabilities now reflected on balance sheets, one of the advantages of leasing rather than buying has been taken away. Although this may mean a podiatry professional may be more inclined to purchase instead of leasing, it is the rare podiatrist who won't continue to consider leasing as an option for financing equipment acquisitions. The benefits of leasing include:

- Tax Management: Leases allow a lessee to more efficiently manage some of their taxes; when they cannot utilize all of the deductions, the lessors can and are able to pass the benefits through via lower lease and rental rates.
- 100% Financing: A lease generally equates to 100% financing of equipment, software, and services with zero down payment. Best of all, less than 100% shows on the practice's balance sheet.
- Keeping Current: Keep current with technology by acquiring more and better equipment compared to loan financing and avoids residual risk because that risk is assumed by the lessor.

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• Cash Flow Management: Smaller, more manageable and flexible payments while the equipment generates the revenue.

• Cash Savings: Save limited cash for other areas of the practice, such as expansion, improvements, marketing, etc.

It's Transparency Once Again

All podiatry practices are required to show their lease agreements on the balance sheet as a Right-of-Use (RoU) asset and a lease liability, with a few exceptions. The related expense will then hit the income statement under two headings—amortization of the RoU asset and gradual and incremental long-term interest growth on the lease liability.

The new standard is designed to improve and clarify the financial reporting of lease transactions. The new lease standard also seeks to provide more transparency by changing the accounting view and the ways that a practice accounts for future leasing transactions. Unfortunately, the new standard will not only have a direct impact on balance sheet and financial reporting but its complexity will present many challenges.

Although the new leasing guidelines don't fully go into effect for privately-held businesses and professional practices until 2020, many will have to go to their lenders to explain the new ratios created by ASC 842. After all, all operating leases will no longer be on the podiatry practice's balance sheet, throwing its ratios out of whack and may require adjustments in existing loan agreements.

Bottom-line, the new rules should have no impact on a podiatry practice's income statement and, thus, there should be no effect on debt covenants. In fact, the FASB has specifically stated that the Lease Liabilities created by capitalizing leases should not be considered debt by most financial institutions.

Of course, modifying existing leases or entering into new leases or contracts will require an understanding of all the implications of the new standards. With adequate information and preparation to implement ASC 842, lessees can continue to reap the many advantages associated with leasing.

Adopting the new standard, complying with the new definitions for lease transactions, and ensuring a minimal impact on the practicing podiatry professional's dealings with potential lenders, suppliers and investors means starting now. And, as always, professional assistance is highly recommended. **PM**

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