The Impact of the New Lease Accounting Standard on Private Clubs

By Amber Stone, CPA, Manager

After many delays, the implementation date for the new lease accounting standard is right around the corner. The standard, known as ASC 842, is effective for years beginning after December 15, 2021 for private companies and many not-for-profit organizations. For clubs that report on a calendar year basis, this means ASC 842 must be implemented for calendar year 2022. For clubs that report on a fiscal year, the standard must be implemented for the fiscal year beginning in 2022. The new lease standard may lead to increased asset and liability balances, as well as require additional analysis and work due to the new calculations needed to determine certain lease expenses.

Refresher on Current Lease Accounting

Before diving into specific details of the new lease standard, it is helpful to remember how leases are currently reported in the club's accounting records. Under the current lease accounting standards, leases are considered either capital leases or operating leases based on certain criteria. Capital leases are commonly known as "balance sheet" leases, since the asset and the related liability are recorded in the club's accounting records at the beginning of the lease. The asset is then depreciated, while the payments to the lessor are broken out between interest expense and principal which is applied against the liability. On the other hand, operating leases are expensed directly to the income statement or statement of activities (collectively referred to as "income statement" hereafter) over the term of the lease, often on a monthly basis.

Overview of Changes

The aspects of the new lease accounting standard that will have the largest impact on private clubs are as follows:

- Leases will now be considered either finance leases or operating leases.
- The asset associated with leases will now be considered an intangible right-of-use asset, rather than a property, plant, or equipment asset.
- All leases – both finance and operating leases – will now have an asset and liability component, which essentially brings all leases to the balance sheet or statement of financial position (collectively referred to as "balance sheet" hereafter). This will be is the most critical change for private clubs.

Finance vs. Operating Lease

If a lease meets any of the following criteria, it will be considered a finance lease:

- Ownership of the asset is transferred to the club by the end of the lease term,
- The lease grants a purchase option that the club is reasonably certain to exercise,

- The lease term is for the major part of the remaining economic life of the asset unless the lease commences near the end of the asset's economic life,

- The present value of the sum of the lease payments and certain guaranteed residual values equals or exceeds substantially all of the fair value of the asset, or

- The asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Any leases that do not meet at least one of the criteria above will be considered operating leases. As you may have noticed, the criteria for finance leases are very similar to the existing criteria for capital leases. As a result, most existing capital leases will now be considered finance leases under the new standard. Meanwhile, existing operating leases are unlikely to meet the criteria and will continue to be called operating leases.

Right-of-Use Asset

Both types of leases will result in a right-of-use (ROU) asset being recorded. The ROU is an intangible asset that will be amortized (not depreciated), may be subject to impairment testing, and must be presented separately from the property, plant, and equipment assets on the balance sheet. The life of the ROU asset will be either the lease term or the expected useful life of the property if the club is reasonably certain that it will take ownership of the property at the end of the lease.

Bringing Leases to the Balance Sheet

At the beginning of a lease, for both finance and operating leases, the liability must be recorded based on the present value of the future lease payments, with the related ROU asset recorded. However, the accounting treatment after the lease commences will follow different patterns for finance and operating leases.

For finance leases, the ROU asset will be amortized on a straight line basis over the applicable life, resulting in amortization expense. At the same time, the liability will follow a standard loan amortization where the payments are split between interest expense and principal.

For operating leases, the total lease expense will be recognized straight line over the life of the lease. To accomplish this, the club must do the following:

1. Determine the monthly total lease expense by dividing the total remaining payments by the life of the lease.

2. Calculate the standard loan amortization for the liability, splitting the payment between interest expense and principal.

3. Subtract the interest expense in step 2 from the total monthly lease expense in step 1 to calculate the ROU amortization.

4. Add the interest (step 2) and the amortization (step 3) to calculate and record the monthly total lease expense. These amounts are combined and reported as one lease expense line item.

For many club operating leases, the annual expense under this new treatment will be similar to the annual expense under the old lease accounting standard; however, the activity now also flows through the balance sheet not just the income statement.

Steps to Take Now

If you have not already done so, we recommend taking the following steps to help prepare:

1. Reach out to your bank/lender to see how they will handle any debt covenants that are impacted by this standard. For example, covenants often include a debt-service coverage ratio which would be negatively impacted by recording the new lease liability for operating leases.

2. Develop a comprehensive list or spreadsheet of all leases and the pertinent lease terms. The list should then be reviewed to determine the proper treatment of each lease going forward, and identify any unique situations that may need additional research.

3. Inform the board and other management of these upcoming changes and the expected impact on the club's reporting and budgeting.

4. As the budget for next year is being developed, consider any adjustments that will need to be made as a result of the new standard.

5. Coordinate with your PKFOD client service team to discuss how the audit/review/compilation services will be impacted.

Final Thoughts

The text of the new lease standard is approximately 200 pages, and contains guidance on many specific situations, including changes to the definition of a lease. Our analysis above is based on our private club expertise and the factors we believe will impact private clubs the most; however, if you have any concerns regarding an unusual lease or a part of the lease standard not discussed above, please reach out to us to discuss your specific situation.

Contact Us

If you would like further information on the new lease accounting standard, please contact the partner in charge of your account or:

Amber Stone, CPA
Manager
astone@pkfod.com

Geoffrey Benedict, CPA, CGMA
Partner
gbenedict@pkfod.com

About PKF O'Connor Davies