Lease Accounting Changes: Three Observations and Three Actions to Take

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The FASB and IASB joint exposure draft on proposed lease accounting changes is pointing to significant changes in reporting that will impact areas from income statements and balance sheets to financial covenants, EBITDA calculations, earn-outs, and compensation agreements.

Deloitte recently released results of a survey[1] of 284 executives that reported on how the proposed lease accounting standards would affect their businesses. Surveyed from December 1, 2010 to January 3, 2011, executives reported the standards would have significant impact on debt-to-equity ratios (68%), debt covenants (44%), and the difficulty obtaining financing (40%).

Following are three observations and three actions that can be taken now to better manage exposure and improve a company's position with regards to lease accounting changes.

1. Leases will be treated as capital leases
Proposed standards would move many leases for real estate, vehicles, and technology from treatment as operating expenses to treatment as capital financial leases on the balance sheet. The affected leases would be recorded both as intangible assets in the context of usage and as liabilities in the context of future lease payments. Lease payments would be proportioned as both interest expense and amortization over the appropriate term.

2. Shifting leverage ratios may impact financial covenants
With appearance of leases as assets and liabilities on the balance sheet, core ratios like debt-to-equity may appear less favorable although there have been no material changes in business operations or cash flow. For example, annual ratio tests executed by banks or other loan holders may reveal that metrics are no longer in compliance with loan requirements. A possible outcome: test results may raise concerns about collectability, categorize the loan covenant as breached, and prompt the bank to call the loan. Yet the company is still in the same (and healthy) financial condition.

3. Potential volatility in financial statements
Changes in the treatment of leases will substantially alter financial statements. Proposals under review do not grandfather in existing leases, and all current leases will require initial assessment and measurement in areas like terms, contingent rentals, and term option penalties. It appears these metrics will need to be updated at each reporting period. Until the final exposure draft provides clarification, fluctuating judgments in areas like what contingent rent is going to be will require up and down adjustments and may contribute to volatility in reporting financial statements.

Preparing for and implementing lease accounting changes will be a significant undertaking, especially for large companies with multiple decentralized locations and large numbers of current and planned leases. Here are three actions that can be taken now to improve positioning.

1. Be proactive: identify resources and begin gathering data
Final lease accounting standards are expected this year. While a precise implementation date has not been set, companies should adopt a proactive stance to determine sooner—rather than later—how the changes will impact their businesses. Consideration is being given to concurrently implementing a large number of changes in standards, and this speaks strongly to starting early. Too, the requirement to address all existing leases suggests a review to assure there are sufficient resources with the right expertise to handle lease accounting changes.

2. Clearly identify the areas that will be impacted
Assess the gathered data to identify impacted areas, and, more importantly, what the effects will be. In the area of financial reporting, it is likely that cash flows and EBITA calculations will appear more positive. Analysis should look at how key financial metrics affect current and future compensation agreements, earn-out agreements, regulatory requirements, and tax filings. Attention should be paid to whether the measurement used for agreements is appropriately written or requires review.

3. Incorporate changes into new covenants and other contract negotiations
Because financial reporting is tightly woven into loan and other financial covenants, consideration should be given to grounding new covenant negotiations in language that addresses changes in lease accounting principles. As mentioned earlier, the new principles may cause a substantial shift in the outcome of a covenant-required leverage ratio test when there has been no change in business operations. New covenants should be written in a way that provides for automatic adaption—with no amendments and accompanying fees—when it appears a covenant has been breached due to changes in accounting principles

In response to ongoing comments and feedback, the proposed standards continue to evolve. Recent developments have included new phrasing around lease terms and the definition of a lease. For example, an earlier definition of the lease term based on longer, probability-weighted "what if" scenarios has been updated with provisions that focus on the non-cancellable period plus options that have a significant economic incentive to renew the lease. Consideration is also being given to continuing straight-line expense of leases in cases where leases do not have substantial financing characteristics.

Taking a proactive stance now on the upcoming lease accounting changes is a compelling risk management strategy that will assure the best possible implementation outcomes.

1 Deloitte Survey: Only Seven Percent of Companies Are Well Prepared to Comply with New Lease Accounting Standards, Press Release, February 16, 2011

About CFO Edge

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