What In-House Counsel Should Know About the New Lease Accounting Standards

By Lance Dunkley

New accounting laws are in the final stages of being enacted. What does this have to do with in-house counsel? For companies with significant space or equipment leases, it is conceivable that the CFO, already reeling from a potential double-digit decline in revenues, will inquire why the company is now in default on its loans. Are you prepared to respond?

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to finalize new accounting practices related to operating leases. In August 2010, the two boards jointly issued an Exposure Draft (ED) of the proposed new standards.

While it's still uncertain which aspects of the ED will be included in the final lease accounting rules, it is certain that the new rules will significantly impact many companies. All industries will have some repercussions due to the rule changes, though the most significant impact may be felt in the retail, real estate, food, airline and financial services industries. If your company is in one of these industries or leases space or equipment, you need to know the new lease accounting rules.

Background

The new rules were originally scheduled to be finalized June 30, 2011, though there was some flexibility with the date as the FASB and IASB indicated a greater interest in getting the final law right than issuing the changes prematurely to meet pre-established timelines. The two groups now expect to release a final standard in third-quarter 2011 with a possible second ED, given the enormity of the changes from the original. The rules are scheduled to take effect by January 2013.

Most of the pressure to comply with the proposed standards will fall to a company's corporate real estate, lease administration, accounting and tax departments when it comes to changes on corporate balance sheets, financial reporting requirements and lease agreements. The changes may also heavily involve technology departments as new systems could be necessary to support the increased administrative burden of updating lease payment adjustments at the end of each reporting period.

What In-House Counsel Need to Know

In-house counsel should become well-versed with how the inevitable changes will impact loan covenants, lease type and terms, buy/lease strategies and reporting compliance.

The objective of the proposed lease accounting rules is to create a common accounting standard to ensure assets and liabilities arising from leases are uniformly recognized on balance sheets. Whether the ED appropriately meets this objective is subject to interpretation and extensive debate. The ED proposes capitalizing operating leases by calculating the asset and liability based upon the net present value of the future rent payments. This means converting rental stream into a principal amount by dividing by a rate of interest (the company's incremental borrowing rate). Both the right to use the leased space or equipment (the asset) and the obligation to pay rent (the liability) are capitalized, leading to increased assets and liabilities in the initial years of the lease term.

Significantly, the ED proposes capitalizing not only base rent, but also estimated percentage rents, and extending the capitalized term of the lease by any extension periods. These changes will cause many companies to incur double-digit increases in reported liabilities the day the new standards are implemented. Currently, a lease can be reported as a straight-line rent payment expense on the profit and loss statement, while not being disclosed on the balance sheet.

Dr. Charles Mulford, Director of the Georgia Tech Financial Analysis Lab, in his research report titled, "The Effects Of Lease Capitalization on Various Financial Measures: An Analysis of The Retail Industry," evaluated how lease capitalization would impact income for 19 major retailers. According to his findings, the median change to total liabilities would be a 26.4% increase. The finding also showed that while earnings before interest, taxes, depreciation and amortization (EBITDA) would increase 22.5%, income from continuing operations and earnings per share would each decrease 5.3%. The retailers' liability/equity ratio could be expected to decrease 26.4%, which would be a significant shift in financial leverage.

Impact

Case in point: A notice issued by the Equipment Leasing and Finance Association included an example of how the new lease accounting standard may impact airline companies. For instance, a 17-year lease on a $100 million aircraft would show a first-year expense under the new accounting standards of $2.4 million or 26% higher than straight-line. The cumulative difference reaches a high point in the ninth year at 128% greater than straight-line.

Companies poorly weathering the economic storm may find the accounting changes devastating. If capitalization is weak, even a small change on the balance sheet could significantly influence profitability. Furthermore, many companies may find themselves in default under their loans because the new accounting standards cause them to be in violation of their financial covenants.

The impetus to include operating leases on balance sheets grew out of the Enron scandal. Between 1993 and 2001, Enron created more than 3,000 partnerships, primarily to hide the company's bad debts. Enron circumvented accounting practices by finding partners to take as little as a 3% stake in a partnership. In these cases, Enron was not required to report the partnership's financial

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condition in its own financial statements and could hide underperforming assets by selling them to the partnerships in exchange for IOUs backed by Enron stock.

In the aftermath of Enron, the Securities and Exchange Commission (SEC) focused accounting reform on off-balance sheet transactions and, in particular, operating leases. The latter have been attractive to companies that lease equipment or space because they offer a payment financing alternative and are excellent for bypassing capital budgeting restraints. An operating lease typically qualifies for off-balance sheet treatment, resulting in increased return on assets due to a reduced asset base.

The right to use property for the term of the lease, as well as extension periods, will be recognized as interest expense and amortization, which results in improved EBITDA. The obligation to pay rent, including percentage rent, during the term of the lease and extension periods will replace rent expense and be recognized as a liability, causing EBITDA to free-fall.

One of the most controversial aspects of the accounting changes is the expected outcome technique. This estimate assumes the longest possible lease term that is "more likely than not" to occur, taking into account the effect of any options to extend or terminate the lease and contingent rentals. Options to extend a lease may be included within the lease term, swelling the impact of front-loading, based on factors such as contractual terms, nature of the asset, location, cost of relocating, lessee's intentions and past practices. Recent meetings of the FASB and IASB focused on the definition of lease term. One recent staff briefing paper noted almost universal rejection by the public to include lease options within the definition of lease term, even if they are judged "more likely than not" to be exercised.

The new standards are also expected to include projected percentage rent as part of the expected outcome over the term of the lease, further increasing the front-loaded liabilities of many already debt-laden companies.

Projections of lease extensions and percentage rent must be updated when changes in facts or circumstances indicate there would be a significant change in the assets or liabilities from the previous reporting period. In some instances, this could lead to monthly reporting changes and, in all instances, it will cause administrative nightmares unless appropriate lease administration processes are implemented.

Is Your Company Prepared For the Change?

According to a February 2011 survey by Deloitte, only 7% of executives said their companies were extremely or very prepared for the accounting standard changes. However, executives universally indicated concerns about the impact on debt-to-equity ratios, the effect on existing debt covenants, an increased difficulty in obtaining financing, a possible move toward shorter-term leases and a change to purchasing real estate rather than leasing space.

Following are areas in which companies should dedicate resources in anticipation of the accounting changes:

- *Impact on loan covenants*: Upon inception of the new lease accounting principles, many borrowers may be in default under financial covenants found in their loan documents.
- *Impact on the term of the lease*: Due to the effect of front-ending lease costs, the new rules for lease accounting impact long-term leases more than short-term leases.
- *Impact on the type of lease (net vs. gross)*: Net leases with lower contractual lease payments may be more appealing than gross leases as lower contractual lease payments will help to minimize the impact of capitalization.
- *Impact on administrative costs*: Administration costs associated with lease accounting changes will increase due to the added complexity of disclosure requirements. Estimates of lease term and lease payments will have to be reviewed every time companies report financial results, which will be at least quarterly for large companies. The added administrative responsibility may also require new or upgraded technology solutions to track and report lease obligations.
- *Impact on the buy vs. lease decision*: The accounting benefits of leasing versus buying will be greatly diminished, moving companies toward acquiring property rather than leasing it. Corporate real estate strategies, however, are also driven by a host of other factors including the cost of capital, capital access, tax considerations, governance and budgetary consideration, regulatory constraints and economic conditions, so the decision to buy or lease will vary by company.

What Can You Do?

The requirements and implications of the new lease accounting standards will affect companies differently, but there are steps that all companies can take in anticipation of these changes. Following the FASB/IASB process as it unfolds in the coming months will be imperative. In addition, in-house counsel and other department executives can take action now to:

- Review, revise and update corporate lease administration systems and processes.
- Proactively strategize with lenders regarding the new lease accounting principles and, if required, plan to restructure existing loans.
- Review and possibly restructure long-term lease obligations, extensions and percentage rent obligations.
- Re-engineer lease/buy models to account for the changes in lease accounting.
- Invest in technology systems to track leasing obligations.

Conclusion

In-house counsel should work proactively with the corporate real estate, lease administration, accounting, tax and technology departments to devise an integrated strategy for optimizing the company's short- and long-term options under the new lease accounting guidelines. An effective plan will help mitigate the impact the new lease accounting standards may impose.