Lease's up

How changes in accounting for leases will affect you **Interviewed by Matt McClellan**

Accounting standards for leases are changing in an attempt to eliminate off-balance sheet transactions and accounting in U.S. and international financial reporting. One of the biggest changes is that operating leases as you know them will be eliminated.

Kamal D. Parag, partner with Habif, Arogeti & Wynne LLP, says the new proposal introduces the 'right of use' concept.

"You have a right of use of the leased asset, which has a value, and you have a corresponding lease obligation to pay for the right to use the asset," Parag says. "Going forward, generally all leases would have to be capitalized on the balance sheet of a company."

The current standards require companies to capitalize some leases if you meet certain requirements. If they don't meet those requirements, companies can keep those leases off their balance sheet.

Smart Business spoke with Parag about how the changes will affect businesses, and how they can prepare.

Kamal Parag
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What are some of the criteria leases must meet?

Generally, any lease of tangible property you have today and going forward would have to be capitalized on the books under this new proposal.

How can businesses accurately measure their assets' value?

You would have to record the asset and lease obligation that are to be measured at the present value of the lease payments over the lease term. And the lease term would have to be determined by estimating the longest possible lease term that is more likely than not to be exercised. Similarly, you would have to consider contingent rental payments in determining this value.

So if you have a five-year lease with built-in options to extend at the end of the first five years for another five years, management has to make an estimate of how long they expect that lease will run. Will they just go the first five years and cancel, or will they stay longer?

That estimate has to be made at the inception of the lease. Then, at each financial statement reporting date, management is expected to reassess that estimate. If it changes significantly, they would have to adjust financial statements accordingly, thus resulting in volatility in earnings.

How will this affect existing leases?

Existing leases will also be covered by the proposal. You have to determine the value of the existing leases and record those on the books for all periods being presented in financial statements that are issued by a company. These changes will affect everyone who prepares financial statements under U.S. generally accepted accounting principles (GAAP).

How will these changes affect companies?

It will definitely affect buy versus lease decisions. Also, companies will be more thoughtful about lease terms and provisions now, like how many options to renew or extensions they have in the document.

It also will place more of an administrative burden on companies. Now you have to maintain all these leases, know when they start and end, know when they have options to renew and extend and, most importantly, you have to keep monitoring changes in the estimates you're making about your leased assets on an ongoing basis.

One of the other big issues that can affect companies is debt covenants. Under current accounting literature, similar lease transactions can be accounted for in different ways.

In some cases, balance sheets will reflect an asset and liability for the lease under the current treatment, and in some cases they don't reflect the asset or liability for a very similar type lease. With the new treatment, all leases will have the asset and liability component built into it. Therefore, when banks look at those financial statements, they will see a lot more debt than before. Generally, you will see an increase in EBITDA but a decrease in the bottom line.

What should business owners do to ensure they are prepared for the changes?

One major factor is proper documentation and maintenance of all your leases, thought processes and assumptions in estimates, which will be particularly relevant in financial statement audits.

Additionally, initiate discussions with your banker about the proposed changes so as to ensure that you remain in compliance and avoid any unwanted surprises and costs. Generally, banks are aware of this change, so ask them if they are, and how it will affect compliance with financial covenants.

How can they avoid breaking compliance?

Businesses should start developing a strategy for initial and ongoing assessments of the leases they do have. There is an exposure document that has been issued. The comment period for that document is expected to end in December 2010, with a final standard expected in the second quarter of 2011, with an effective date of 2012.

Companies should initiate a discussion with their banker to come to some kind of resolution. They can do an amendment, modification or even a waiver of certain covenants. They don't want to disrupt their business for this change; they should ask the bank for some type of modification or leniency in this period of transition. <<

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