

## White Paper

# Dramatic Changes Expected in Lease Accounting: Are You Prepared?

Potential changes in lease accounting may have seismic consequences for the balance sheets of public companies: Operating leases will likely be replaced by capital leases, resulting in the shift of trillions of dollars to balance sheets of companies worldwide. With all leases for commercial real estate being capitalized in this way, the debt of most companies will increase dramatically.

Historically, leases of real estate and equipment have been a critical source of financing used by almost all corporations, with an annual volume of 760 billion US dollars, according to the 2009 World Leasing Yearbook. However, the assets and liabilities arising from many of those contracts aren't currently found on balance sheets. Accordingly, in an attempt to standardize leases worldwide and promote transparency and understanding in financial reporting, the rules of the accounting game will likely be changing for tenants (with new regulations for landlords coming next).

With so much at risk, tenants need to understand the proposed new accounting standards and begin to plan ahead now. Why is this so timely? Because all leases that exist as of the official change in regulations will reflect the new standards and will not be grandfathered.

### Why Are Proposed Changes Moving Forward?

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued a joint Discussion Paper (Leases: Preliminary Views) that details the general changes introduced above. The impetus for the proposed changes dates back to the Enron scandal and other corporate bankruptcies, which raised concerns about off-balance accounting. In 2005, the Securities and Exchange Commission recommended that FASB scrutinize existing lease accounting standards.

Until this point, FASB and IASB have split leases into two categories: capital (or finance) leases and operating leases. With capital leases, the assets and liabilities are recognized on the balance sheet, as is the case of an asset financed by a loan. With operating leases, the lessee simply recognizes lease payments as an expense when they are incurred, or paid. Most companies prefer this kind of arrangement, since less debt is reported on the balance sheet.

However, the split into these two categories has led to concerns, including:

- Undisclosed liabilities in the form of lease obligations.
- Lack of transparency and comparability.
- Opportunities to structure transactions to achieve a particular lease classification that may be difficult to understand.

While the balance sheets of corporations are often adjusted in an attempt to reflect a fair approximation of the debt the leases imply, critics claim that these adjustments are inconsistent and frequently understate the obligations of the leases.

## What Are the Specifics of the New Proposal?

The proposed standards are based on the premise that all leases give rise to assets (the “right to use” the leased assets) and liabilities (future rental payments).

The proposed new, basic principles for lessee accounting are:

- There will be no distinction between operating leases and capital leases.
- Leases will be capitalized based on the present value of the lease obligation.
- The capitalized lease value will include the base rent as well as residual payments, obligated renewals, and contingent rents.
- Rent expenses will cease to exist; the lease will be recognized as an asset financed by debt.
- Balance sheets will include a category for leased assets separate from other fixed assets, which include owned assets.

## How Will this Affect Tenants?

Proposed changes are inevitable, and the repercussions will be considerable. Virtually every organization will be affected, since almost all businesses lease assets, including real estate, computers, office equipment, vehicles, etc.

With these assets and liabilities added to corporate balance sheets, companies will need to change the presentation and measures on their balance sheets. Since most corporations use measurement metrics for a variety of purposes—including debt covenants, assessment of financial performance, management compensation, and forecasting—it will be challenging for them to adapt to the new requirements.

Other challenges include the following:

- Corporate balance sheets will inflate significantly. According to stress tests recently performed by federal regulators, as the leases and corresponding liabilities are added to the balance sheets of the 19 largest US banks, their balance sheets could expand as much as \$900 billion—and the total impact on all US corporations will be much greater.
- Many companies will appear more highly leveraged.
- Expenses related to lease assets will no longer be straight lined; rather, occupancy expense will be higher in the earlier years (as much as 15%) and lower in later years.
- Metrics such as Debt to Equity, Interest Coverage, EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), and Return on Assets will change, and comparability to prior periods will be affected.
- An increase in EBITDA (cash flow) due to reduction in rent expense will be offset by amortization and financing charges added back to cash flow.
- Corporations will face a heavy administrative burden since they will have to collect and input substantial data and perform complex calculations to determine the amount to be capitalized. They will need to plan for new processes and software to facilitate the necessary changes.

## What May Happen if Tenants Don't Act?

Most companies have not developed a corporate strategy to address this issue or have been slow to start their transition plans. Whatever their reasons—a preoccupation with other vexing financial matters, a perception that this doesn't require immediate attention, waiting for more disclosure by the accounting boards, etc.—companies that don't act do so at considerable risk.

The fact is, with no strategic response in place, many companies will face an acute short-term dilemma: ***They may violate their debt covenants and be in loan default.***

Defaults may start small and then flow into a ripple effect. When approached to modify the terms of debt, lenders may require costly incentives such as an escalated interest rate, debt pay-down, or an enhanced capital position. This will likely lead to significant legal expenses and exhaustive manpower efforts.

## What Should Tenants Do?

The proposed accounting changes are complicated, their implications are daunting, and no quick fix exists. Still, companies need to be proactive and begin the process of understanding the issues and then addressing the options that best meet their needs.

The first step is to meet internally with accountants and consult with real estate advisors who specialize in capital markets. These experts can review alternatives and help secure financing.

In general, tenants should pursue a strategy that maximizes their asset value and liquidity, reduces occupancy costs and liability, and improves their bottom line.

Specific considerations regarding the impending new standards include:

- **Look into buying vs. leasing.** Since your asset will be on the balance sheet anyway, it may be more advantageous to purchase your property or equipment, as is now more customary in Europe.
- **Negotiate short-term or long-term vs. mid-term leases.** Leases of fewer than 10 years will result in higher rental rates but will reflect less debt on the balance sheet. Mid-term leases (10 – 15 years) may result in a comparatively large debt burden. Efficiently financed long-term leases (ideally 20-plus years), though non-traditional, may be better financial alternatives due to lower obligations in later years.
- **Review alternatives for creative financing and lease structures.** Given these changes in lease accounting, there will likely be even more pressure on securing cost-efficient leases. Many corporations have scrutinized how much of their cash is invested in real estate and have been considering options to free up this capital so it can be reinvested in other areas of their business. **Corporate sale/leasebacks**, in which one party sells an asset and then leases it back for a long term, have had a recent surge in popularity as a source of cash. These new provisions will force a broader examination of financing options for sale/leaseback transactions.
- **Determine your new financial ratios (debt/equity and interest coverage ratios).** These ratios are key to securing capital, as they indicate the long-term solvency of a company. Borrowers should begin discussions early with lenders regarding this proposed accounting change to communicate the nature of this change and help the debt holders understand that their risk position should not change as a result of this financial re-classification.
- **Protect your interests.** Consider the advantages of working with a corporate real estate advisor that exclusively represents tenants, assuring that you have an advocate who will negotiate the most favorable terms with landlords and avoid conflicts of interest.

## What's Coming Next?

While the Discussion Paper provides a framework for the future, it acknowledges topics for which there is no present agreement between the FASB and IASB. Among the issues to be decided are: sublease treatment; build-to-suits; short-term and small-sized leases; lease options such as purchase, renewal, expansion, and reduction; contingent rents; and measurement of leases already in place.

An exact date for the formal adoption of the new standards has not been determined. The boards of FASB and IASB are planning subsequent papers on new proposed standards in 2010 and 2011, and there is speculation that these standards won't go into effect for another three to four years. In the meantime, public comment on government proposals (now and in the future) is welcome. To view the Discussion Paper and submit comments, visit [www.fasb.org](http://www.fasb.org) or [www.iasb.org](http://www.iasb.org).

While tenants can't affect how quickly the wheels of public policy will turn, they can be proactive and put their own initiatives in motion. The process may be complicated (transparency does not necessarily equate to simplicity), and it may incur some time and initial cost. But the road will be much smoother if the journey starts now, and the long-term payoffs should prove to be significant.

Think of it this way: Companies may continue to fight for survival, but they don't need to be buried prematurely by debt.

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