

Rule Changes

How new standards for lease accounting may impact balance sheets

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If your company leases real estate or equipment, proposed changes in lease accounting standards could add significant debt to your balance sheet, change the way your business is perceived by investors and shareholders and even threaten your company's compliance with its loan covenants.

The new standards are outlined in an "exposure draft" released jointly by the Financial Accounting Standards Board and its counterpart, the International Accounting Standards Board. Compliance could be required as early as 2013.

What changes are proposed?

The new standard effectively transforms all leases into capital leases by doing away with the "90 percent rule" under which a lease is considered an operating lease if payments amount to less than 90 percent of the value of a lease asset. Publicly traded U.S. companies will be forced to capitalize some \$1.3 trillion of new debt.

How could the changes affect your company?

The threat to financial loan covenants is among the most significant consequence of the new accounting standard. Companies that are within — perhaps even well within — their current loan covenant ratios can find themselves in default after they add all lease assets and liabilities onto their balance sheet.

Companies may need to increase the equity on their outstanding loans or have their lines of credit revoked.

If passed as outlined, the new standards will require your company to:

- Calculate the value of currently contracted lease renewals — and renewal options — and treat that value

as an asset or liability, a daunting prospect for companies with many leases, such as retail food chains.

- Capitalize contingent leases — those tied to sales volume — by forecasting sales over the life of a lease (and its contracted or optional renewal periods) and including those sales projections as assets or liabilities on the balance sheet.
- Estimate expected lease payments, if tied to the consumer price index or another index, using forward rates if available, or prevailing rates if not.
- Apply the new standards to existing leases immediately in the new standards' first year.

Because most companies will appear more highly leveraged under the new standards, some metrics derived from balance sheets will need to be adjusted or new metrics created.

Is there any good news?

In the past, investors, banks, and rating agencies have accounted for "off balance sheet" leases in their assessments of a company's risk levels, and they have adjusted a company's leverage accordingly.

Therefore, the information needed to comply with the new standards should be accessible, but it must be integrated into the new accounting standard protocols. The new standards will also increase transparency in financial assessments and standardize reporting across national borders.



What should your company do right now?

First, you will need to calculate the value of your current leases and then apply the new proposed standards to assess their effect on your company's performance and growth projections, including your loan covenants.

Based on your company's exposure, you may need to: modify or change outstanding loans to exclude capital leases or minimize their effect on loan covenant ratios; reconsider renewal options; revise metrics used to evaluate/forecast company performance and management compensation; renegotiate lease terms, rates, and renewal options; consider short-term, rather than long-term, leases; and consider converting current leases to purchases.

With compliance scheduled tentatively for 2013, you need to begin now to determine how your company could be affected by these new standards. ■

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