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How Will the Proposed Lease Accounting Affect Your Company?

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working on a joint project that will significantly change the accounting for operating lease agreements. This project came to rise for many reasons, including merging with international standards and the clear desire from the investment community for more accurate information in regards to operating leases and the related obligations. It will require future rental payments under a lease to be recorded as a liability and the right to use the related asset to be recorded as an asset on a company's balance sheet.

Effects on Financing

Because long-term lease contracts may substantially increase a company's outstanding debt on its balance sheet, this new requirement potentially could have an adverse effect on bank covenants and future financing decisions. Even though current guidance requires that operating leases be disclosed in the footnotes to the financial statements and many banks have stated that these future obligations are already considered in financing decisions, the additional disclosure requirements and increase in debt on the balance sheet may alter future decisions. This is due to the effect on financial statement ratios and debt covenants, potential adverse affects on the leasing industry, and potential decreases in credit scores.

How will lease extensions be handled?

Lease extensions will be required to be recognized on the balance sheet if it is "more likely than not" that the lease will be extended. Management will have to reevaluate the lease term at each reporting date and revalue the asset and liability as needed. Because of the requirement to include future lease payments as a liability, there may be a trend towards shorter lease terms, removal of extension terms, and/or purchasing assets rather than leasing.

Contingent Rent

Another complication with this proposed guidance relates to contingent rent. Contingent rent is usually based on future financial figures or targets, such as the Consumer Price Index or future sales. With a contingent rent that is based on sales targets, management will be required to estimate future sales in order to determine what their lease obligation will be. This has caused controversy because of the unknown nature of the estimate, the fact that this is not a legal obligation of the entity until the financial target is reached, and the complexity of calculating the estimate at each reporting date. The standard also will require utilizing a probability factor in the calculation of future contingent rental payments. If approved, this provision will prove to be very complex.

Management Considerations

- Because the proposed standard will require the lease obligation and the related asset to be recorded on the balance sheet, management will need to analyze whether it would be more beneficial to purchase or lease property. With this decision, management will need to consider cash flow requirements, effects on financial statement ratios, and future financing requirements.

- If management decides to continue leasing, they also will have to analyze the lease terms, including managing future cash flows. Shorter lease terms most likely will result in higher rates; however, longer lease terms will result in higher debt balances on the balance sheet.

- Management should review debt covenants and other corporate agreements (including bonus and compensation agreements) and consult with attorneys and lenders as to the effect this standard will have on these agreements and whether they should be amended to reflect the new standard.

An exposure draft is expected during the third quarter of 2010 and is expected to be effective in 2013.

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