Five Steps to Plan Ahead for the New Lease Accounting Standard

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On November 11, 2015, the Financial Accounting Standards Board voted to proceed to issue its final accounting standards update on the new lease accounting rules, which will be a significant change to the current lease accounting rules used in accounting principles generally accepted in the United States of America ("US GAAP") today. The new lease standard will require all leases greater than one year to be included on a company's balance sheet for the lessee. The new lease standard is expected to be published in early 2016 and will be effective for public companies for annual and interim periods beginning after December 15, 2018, and for private companies for annual periods beginning after December 15, 2019. Early adoption will be permitted.

The most significant change of the new lease standard to a lessee is that a right-of-use asset and a liability representing the present value of the future lease payments will be recorded on the balance sheet. The standard will introduce the concept of Type A and Type B leases. Under a Type A lease, which is similar to many capital and equipment leases today, the right of use asset will be amortized to the income statement separate from interest, and interest expense would be recorded for the portion of the lease payments that represent interest. Under a Type B lease, which is similar to today's operating lease, the total expense would be recorded to a single total lease expense. The accounting for a lessor under the new standard would be similar to the current accounting rules today.

Since these forthcoming changes in the lease accounting rules are significant to a lessee, we recommend that companies start thinking now about the effects that these new rules will have on their leases. The following are five steps that businesses can do now to ensure that they are prepared for the implementation of this new standard once it becomes effective.

1. Take "Inventory" of Leases

The first step to prepare for the effects of the new lease standard is for companies to perform an analysis on their capital and operating leases as they stand today. The analysis should also include leases that are projected to be entered into or current leases that will be amended in the upcoming years. Once the inventory is complete, companies can determined the effect that the new lease standard will have on their financial statements both by adding the leases to the balance sheet as well as the income statement effects that the ongoing future activities will have on the results of operations.

2. EBITDA Impacts

Since many companies use Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") to measure a company's performance, this new lease standard will likely have an impact on EBITDA, and for companies with multiple leases, this impact could be significant. As discussed above, Type A leases will likely result in an increase to EBITDA since amortization of the right-of-use asset and interest related to lease payment will likely be added back to earnings. EBITDA will likely decrease for Type B leases since the entire expense will be recorded to operations. Companies should consider the effects that the new lease standards will have on their current and future EBITDA amounts.

3. Debt Covenants

Companies that have credit facilities that require financial covenant compliance on a periodic basis will likely be affected by the new standard. In most cases, the lease obligation will be split into current and long-term portions. This will affect such ratios as current ratio, working capital and other ratios that involve current liabilities. Additionally, some banks may now consider the lease obligation amounts as debt, so the debt to equity ratios may be affected. It is advised that companies work with their financial institutions in the next couple years to discuss the impacts that the new lease standard will have on their covenants and consider revising the compliance requirements as necessary to avoid violations.

4. Cash Flows

When companies are negotiating leases, the timing and amount of monthly lease payments is an important factor to both the lessee and lessor. Items as rent abatement (free rent), rent increases over the lease term and tenant improvement allowances are examples of negotiating points when entering into new leases that ultimately affect a lessee's cash flows. Although the new lease standard will not affect the timing of payments on current leases, it could affect the negotiations of the cash flows and other financial incentives of new leases that will be entered into in the future. Before entering into new leases, companies should perform an analysis of the financial statement effects under the guidelines of the new lease standard.

5. Educating Team Members

Since the US GAAP lease rules haven't had a significant change since 1976, it will be important to educate team members of these new rules. This will be particularly important when performing the evaluation as to whether a new lease will be considered a Type A or Type B lease. It will also be important to ensure that team members account for the future ongoing lease activity properly.

Although the new lease standard will likely have some material financial statement impacts for lessees, planning ahead for these changes with stockholders, financial institutions and other financial statement users should result in a smooth and efficient implementation of the new lease accounting rules.

To learn more about the new lease accounting standards, contact Michael Cole at 562.216.1806 or michael.cole@hcvt.com.