

Leasing changes

How impending changes to accounting for operating leases will affect your business **Interviewed by Matt McClellan**

The Financial Accounting Standards Board (FASB) issued a proposal in August that could dramatically change the nature of accounting for operating leases.

"It's part of an effort to conform U.S. accounting standards to international rules," says James C. Suttie, CPA/ABV, CVA, a principal with Skoda Minotti. "And it is in response to criticism that U.S. accounting doesn't currently record a liability for operating lease obligations, although a company could be obligated to fulfill a lease for the next few years. If it is an operating lease, there is currently no asset or liability recorded on the balance sheet under U.S. accounting rules."

Smart Business spoke with Suttie about the new proposal and how it will affect businesses with operating leases.

What is the reason for this new proposal?

There has been a push over the last several years to standardize things on a worldwide basis. If you look at international accounting standards, the thought is, 'We do it this way in Europe, but if we do it a different way in the U.S., it can cause confusion.'

The impact on small businesses can be an undue burden, not just with this proposal, but when an effort is made to standardize things across the board for both privately-held and publicly-traded companies. They live in two different accounting universes, so to speak. So what's good for the goose is not always good for the gander. With that said, you still have to follow the rules.

How will this affect accounting for operating leases?

There are going to be a couple of significant changes if and when this is enacted. Leases would be recorded as a depreciable, "right-to-use" asset on the balance sheet with an equal offsetting liability. There is also going to be a front-loading of expense, similar to the way a mortgage works. With mortgages, you pay more interest early on and then, the interest expense decreases as the loan draws to its conclusion. Leases would work in a similar fashion, and the principal obligation of the lease liability would be paid down slowly as the term of the lease matures.

Are existing leases exempt?

No. The proposal will affect all leases. So, for example, if you have a current operating lease that you have had for two years and



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there are still three years remaining on the lease, you would have to record the lease as an asset at the net present value of the remaining term at that point.

How would this impact financial reporting?

If and when this becomes effective, you would record a right-to-use asset and related liability as separate lines on the balance sheet.

This would also impact the statement of cash flows. Currently, under U.S. standards, operating leases are considered a period expense. That means that lease payments are considered a cash flow from operating activities, as they are just included in net income. However, under the new proposed standard, it would be similar to a capital lease — you would have payments on the lease reflected as cash flows from financing activities as opposed to operating activities.

Other factors to consider are the challenge of estimating the most probable lease terms/extensions and contingent rentals. These can affect current income if you don't get it right upon adoption of the proposed standard.

If you have financial statements that have disclosures, you would be required to disclose in a table the changes in the asset and related liability from the beginning of the year to the end of the year in the footnotes.

In addition, especially with small businesses, it could impact financial ratios and in

turn have an impact on the loan covenants a small business may have with their bank. So businesses may want to look at renegotiating their loan covenants with their bank. This would have an impact on leverage ratios and working capital ratios because you are essentially recording current liability for the current piece of this lease whereas under current rules, you're not recording a liability at all.

So again, companies may want to talk to their banks about renegotiating those loan covenants. It will also have a positive impact on earnings before interest, taxes, depreciation and amortization (EBITDA) because you are capitalizing an asset as opposed to directly expensing it in the current period through lease expense.

When should businesses begin preparing for this?

Again, it is a proposal. There has been no effective date that has been announced. 2013 is realistic, however; it would be adopted retroactively. That means the earliest period presented in your financial statements would have to be adjusted for the adoption of this new standard. Companies should be prepared to account for this as of January 1, 2012.

What should businesses do to prepare for this?

We are recommending our clients evaluate all leases and determine whether or not they have a liability there, and that any modifications to existing leases can be properly evaluated and recorded.

In addition to determining the financial impact on your ratios, it's also important to review your existing capitalization policies. If you don't have one, there might be a threshold where you can capitalize everything over a certain amount but expense everything under that amount. If companies set that amount, you may avoid an undue burden for leases on smaller items like office copiers and such, where you may be paying a minimal amount per month, which may fall under the threshold of your capitalization policy.

Finally, we recommend our clients assess the impact on their tax accounting as well, because it will create another difference between what we call 'book and tax.' So what you capitalize for financial statement purposes is not necessarily capitalized for income tax purposes. <<

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