The Issue

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Lease Accounting Changes May Impact Your Ability to Borrow!

Talk to your Lender: Pervasive Change is coming

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One of the more fundamental principles of accounting is about to change: the way we account for leases. Were it not for the fact that leasing affects nearly every business large or small, public or private, profitable or not profitable, this upcoming change might just be a footnote relegated to a specific industry group or some esoteric principle applied by a relative few. After all, the basic tenets of lease accounting have been with us since November 1976, when the fairly new Financial Accounting Standards Board issued Financial Accounting Standard No. 13 Accounting for Leases.

For almost 40 years, leases have been characterized as either operating leases, meaning the costs associated with the lease from the tenant's point of view were expensed in the current period, or capital leases, in which the lease took on more of the characteristics of ownership and a financing. In the latter case, the costs associated with the lease were capitalized and amortized over the lease term, while the repayment obligation was treated as a loan, with an interest cost associated with it.

Other than a brief overview of the underlying principles, it is not our intent in **The Issue** to get into the technical accounting requirements of the proposed changes. Those requirements are amply covered by a 343 page Proposed Accounting Standards Update (Revised) on Leases (Topic 842) issued on May 16, 2013 by the Financial Accounting Standards Board, and available on their website.

Rather, the purpose of this issue of **The Issue** is to make our clients aware of the implications the proposed standard will have on their financial statements

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and their ability to obtain or retain financing in light of this change in principle. And while the Proposed Lease Accounting Update deals with both lessees and lessors, this issue of **The Issue** will deal with solely with lessees, who represent the bulk of our clients.

Background

The Financial Accounting Standards Board (FASB) represents that readers of financial statements have been concerned for a long time that the current standards, particularly as respects operating leases, fail to recognize the inherent right of use of an asset and the accompanying obligation to pay for that use over time on the entity's Statement of Financial Position.

Under the new standard, a lessee would recognize assets and liabilities for leases with a maximum possible term of more than 12 months. The lease liability would represent the obligation to make lease payments and a right-of-use asset would represent the right to use the underlying asset.

For practical purposes, leases would be classified into one of two types. For most leases of assets other than property (for example, equipment, aircraft, cars, trucks), a lessee would classify the lease as a Type A lease and would recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments. Thereafter, the lessee would recognize the unwinding of the discount on the lease liability as interest, separately from the amortization of the right-of-use asset.

For most leases of property (that is, land and/or a building or part of a building), a lessee would classify the lease as a Type B lease and would recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments. Thereafter, the lessee would recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

An Example

Ok, enough of the technical talk, what does this is all mean? Let's view this by way of example. For purposes of this example, the simplest set of assumptions covered by the literature are assumed. The purpose of the example is simply to illustrate the impact of the new principle on the basic financial statements, and how third parties, in particular, lenders who have imposed covenants on the operation and financial position of the business, might view the impact of this new principle.

Assume a company has sales of $10 million per year, and makes $510,000 in profits annually after taxes. The company signs a five year real estate lease at the beginning of Year 1 with annual lease payments of $1.0 million. Under the existing accounting principles, this lease would normally be considered an operating lease, with lease expense recognized ratably over the lease period on a straight-line basis, and no impact on the balance sheet. Under the proposed principal, this lease would

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be considered a Type B lease, and the right of use asset and the lease liability placed on the balance sheet. Assuming an incremental cost of capital of 5.25% (prime plus 2% currently), a right of use asset and a corresponding lease liability would be initially established on the books at the discounted present value of $4.389 million. During the ensuing first year, the company would recognize a single lease cost, combining the unwinding of the discount on the lease liability ($212,000 in this case) with the amortization of the right-of-use asset ($788,000 in this case), a total, equivalent to the lease expense, of $1.0 million.

Assuming $500,000 in depreciation, offset by purchases of new property, plant, and equipment of a like amount, the balance sheet at the beginning and end of Year 1 would look something like this:

Base Year - Pre-implementation		*Year 1 - Post Implementation*	
Assets		**Assets**	
Cash	500	Cash	510
Other Current Assets	1,500	Other Current Assets	1,500
Total Current Assets	2,000	Total Current Assets	2,010
Property Plant & Equip	2,500	Property Plant & Equip	2,500
		Right of Use Asset	3,601
Total Fixed Asset	2,500	Total Fixed Asset	6,101
Intangibles	1,000	Intangibles	1,000
Total Assets	5,500	Total Assets	9,111
Liabilities & Equity		**Liabilities & Equity**	
Accounts Payable	900	Accounts Payable	900
Current Portion of L.T. Debt	500	Current Portion of L.T. Debt[1]	1,331
	1,400	Total Current Liabs	2,231
		Lease payable	2,770
Loan Payable	2,500	Loan Payable	2,000
Equity	1,600		2,110
Total Liabilities & Equity	5,500	Total Liabilities & Equity	9,111

[1] Includes current portion of lease obligation

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The income statement in this example looks remarkably the same, pre- and post-implementation. This would not be true if Type A leases were involved.

Base Year - Pre-implementation	
Revenue	10,000
Cost of Sales	6,000
Gross Profit	4,000
Rent	1,000
Other Operating Exps	1,500
Depreciation & Amort	500
Net Operating Income	1,000
Interest Expense	150
Net Income before taxes	850
Income Taxes	340
Net Income	510

Year 1 - Post Implementation	
Revenue	10,000
Cost of Sales	6,000
Gross Profit	4,000
Rent	1,000
Other Operating Exps	1,500
Depreciation & Amort	500
Net Operating Income	1,000
Interest Expense	150
Net Income before taxes	850
Income Taxes	340
Net Income	510

But now let's look at the ratios lenders often look at to evaluate the financial condition of their borrowers:

	Pre	**Post**
Current Ratio	1.4	0.9
Debt / Equity Ratio	1.88	2.89
Debt Service Coverage	1.54	1.54
Tangible Net Worth	600	(2,491)

Current Ratio: The current ratio is a measure of liquidity, calculated by dividing current assets by current liabilities. A ratio of 1.0 means that the company has just enough assets that will become liquid in one year's time to offset those liabilities that will mature in one year's time, and is considered a bare minimum. Note in the example, the shear implementation of Topic 842 would reduce the Current Ratio from a healthy 1.4 to an unacceptable 0.9, without changing any of the economics of the underlying business.

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Debt/Equity Ratio: The Debt / Equity Ratio measures the company's leverage, reflected by the relative amount of debt in relation to equity. Industry-by-industry values will vary, depending in large part on whether the industry is a capital intensive one. The higher the ratio the more debt the company has in relation to equity. Note how the implementation of Topic 842 causes the Debt / Equity Ratio to skyrocket, due merely to the recording of the lease liability on the balance sheet.

Debt Service Coverage: Debt Service Coverage measures the ability of the company to service debt out of its operating earnings, and is generally measured by taking the company's earnings before taxes and interest and dividing it by the debt service. Since it is unclear whether lease expense under Topic 842 will be construed as "debt service", it is uncertain how this measurement will be construed. For purposes of illustration, we have assumed it will not have an impact.

Tangible Net Worth: Tangible Net Worth is the measurement of tangible assets less liabilities. It excludes intangible assets such as goodwill, customer lists, workforce in place, trademarks, and the like which would bring little, if any, value in a liquidation. There is a lot of room for interpretation here, and different banks will view what constitutes an intangible asset differently. Suffice it to say, that some banks may construe a Right-of-Use Asset to be an intangible, since the lessee has no ownership right, no ability to pledge or otherwise encumber the asset, and the asset would have no value in liquidation, except perhaps in a bargain lease situation. Note that a conservative interpretation of the Right-of-Use Asset as an intangible, drives the Tangible Net Worth into significant negative territory, again without changing the fundamental economics of the business.

FASB Status

The discussion of a change in accounting principle for Leases is a joint project of the International Accounting Standards Board (IASB) and the FASB. On May 16, 2013, the FASB issued a proposed Accounting Standards Update, Leases (Topic 842): a revision of the 2010 proposed Accounting Standards Update, Leases (Topic 840). The Proposed Standard has been through a period of public comment (September 2013) and is now the subject of additional study. Although originally slated for action in the 1st quarter of 2014, an in-depth discussion transpired at the IASB/FASB Board meeting of January 23rd, 2014, and no decision was reached. The Boards directed the staff to perform further analysis on those topics for discussion at a future Board meeting. Although the next scheduled Board meeting is February 12, 2014, no specific date has been set for the review of staff analysis, or for action by the Boards.

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Action Required

This Newsletter should be a call-to-action for any borrower whose lender has imposed loan covenants based on financial ratios that may be impacted by the implementation of Topic 842. Most of the lenders we have talked to have not taken a position that the impact of Topic 842 would have on their lending practices, adopting a "wait-and-see" attitude to see whether (1) the standard is adopted (there is always a chance it won't) and (2) what impact it will have on their borrower's at that time. The problem from the borrower's standpoint is that it leaves too much leverage in the lender's hands, and the failure to meet covenants could severely constrain the borrower's ability to borrow, result in a loan being frozen, termed out, or becoming immediately due and payable, with disastrous consequences for the business.

While it is reasonable to expect that most lenders will have to reach a rational accommodation with its borrowers in the face of massive covenant defaults, it is better to deal with the issue upfront, and negotiate "what-if" terms into your loan at origination or renewal time.

Perhaps if enough borrowers raise the issue now, the consciousness of the banking community will be elevated to a level where they will no longer be able to ignore it and, in the interest of their borrowers, take the issue head on. We can only hope.

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He leads our financial systems, technical accounting, equity crowdfunding, and corporate governance practice groups.

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