



BLYTHE GLOBAL ADVISORS
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Perspective from Marc Blythe

As the convergence of U.S. GAAP and IFRS standards makes progress, interim changes confirm that the new rules will have a significant effect on how all companies report financial results.

Regarding lease accounting, proposed rules issued thus far will affect balance sheets substantially – enough in some cases to make companies reconsider their leasing strategies.

With final standards expected mid-2011, wise companies will start reviewing their approach to lease accounting now.

Under the Security and Exchange Commission's (SEC) support for a single set of global accounting standards, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) continue to make progress on numerous convergence projects. Once completed, the new rules will apply to all U.S. companies – public and private, large and small – and will have a significant impact on financial reporting.

Although no specific date has been announced for mandating full implementation of IFRS, the FASB and the IASB plan to issue final rules in key areas by mid-2011, with mandated implementation to follow. Last year, U.S. and international accounting bodies published planned changes to lessee accounting. With the groups now expanding their scope to include lessor accounting and an Exposure Draft due later this year, it's expected that there will be substantial debate before rules are finalized.

In this newsletter, I'll focus on the changes to-date on lease accounting. As currently issued, the changes apply to all long-term leases and most short-term leases and include everything from heavy industrial equipment to investment property to non-core assets. I'll discuss the effect these changes will have on lessees' and lessors' balance sheets and processes, and I'll suggest steps companies can take now to be ready when full implementation is mandated.

The Current State of Lease Accounting

From start-ups to global entities, leasing is an important part of most companies' financial portfolios because it enables the acquisition of critical items without large capital outlays. According to current accounting rules, leases are classified as either operating leases or financial leases (also known as capital leases). Operating leases are recorded as an expense item throughout the term of the lease; financial leases are recorded as assets on the company's balance sheet with associated liabilities, risks, cash flows, debt, etc. In this two-tiered scenario, companies often delegate the negotiation, acquisition and management of most operating leases to their procurement or facilities departments – or even to the specific department requiring the leased

items – with little or no accounting department involvement. The monthly invoice is recorded as an expense and usually signed off by a manager. The monthly payment check usually requires only one signature.

Not any more.

The Future State of Lease Accounting

Under the new global rules, operating leases will be eliminated. All leases will be financial leases – in the majority of cases, regardless of what is being leased, the term of the lease or the cost. To be clear, under the new rules, all operating leases will be reclassified as financial leases on the mandated implementation date.

For lessees, this means that on the mandated implementation date, company balance sheets must be updated to reflect an asset and liability for every newly classified financial lease. An operating lease that might have been recorded as, say, a \$5,000 monthly expense over its term, will become a balance sheet right-to-use asset possibly valued in six figures – along with associated liabilities, risks, cash flows, debt, etc. Also effective on day one of implementation, companies will be required to recognize such assets and liabilities **immediately** upon entering into contracts for new leases.

Companies holding many such leases could find their financial picture significantly altered. Some might find it beneficial – what was formerly an operating expense could now be a depreciated item resulting in higher EBITDA. Other companies might find it detrimental – the perception of higher debt ratios could cause senior management to rethink critical assumptions about how they run the business and perhaps decrease or limit leasing activity.

These changes will clearly require companies to revamp their approach and management of leases. Workloads will increase for those who negotiate leases and those who keep the books. Companies that change behaviors and processes today will be better positioned when compliance is required.

Here's a broad overview of what needs to take place.

The accounting function will need to be more heavily involved in all leasing deals from the outset. They'll need to be better educated on the complexities of leasing not only to help drive the best deal for the company (often in tandem with procurement and facilities) but also to enable an accurate estimate of right-to-use asset and liability values over the term of the lease. These complex issues (and assumptions) include but are not limited to lease term, purchase options, escalation clauses, contingent rentals, residual value guarantees, usage fees, discount rates, etc. To do all this successfully and meet compliance, companies will need to upgrade internal processes and policies.

Accounting management will need to get comfortable making more judgment decisions – contrary to current practices. Using their newly acquired leasing knowledge, they'll need to apply multiple assumptions to come up with accurate initial and subsequent values of a lease's asset and liability over its life. If a material change occurs, management will need to re-measure the value at each reporting date. Senior management will need to get comfortable signing off on those judgment decisions. Further, the implementation of more judgment decisions will require more disclosures and transparency.

All leases will need higher levels of accounting approvals commensurate to the estimated asset value. And while procurement and facilities can – and should – participate in the effort to locate all leases currently in place, the accounting department needs to launch a concerted effort to determine asset values, liabilities, risks, etc. on all those existing leases.

Smaller companies – where managers often wear multiple hats – will need to make similar

changes. Both large and small companies might need outside resources to handle a temporary increase in workload.

Lessors will also be affected.

Under the new rules, once a lessor enters into a contract granting a lessee the right to use the leased property, the lessor must record that property on the balance sheet as both a liability represented by the obligation to permit the lessee to use its property and as a “new asset” represented by the lessor’s right to receive payment from the lessee. Like lessees, lessors will need to consider issues such as purchase options, escalation clauses, contingent rentals, residual value guarantees, usage fees, discount rates, etc. in estimating initial and subsequent measurements. Also like lessees, lessors will need to apply multiple assumptions to come up with accurate initial and subsequent values of a lease’s asset and liability over its life.

The full scope of changes to both lessee and lessor accounting will be better known when the Exposure Draft is published later this year.

Some Steps to a Smooth Transition

Because accounting firms need to maintain independence and avoid conflicts of interest, they are precluded from providing too much advice to clients. As a result, they often recommend accounting and financial reporting consultants to bridge the gap and bring the required expertise in-house. Here is how such a consultant can help both lessees and lessors get up-to-speed now and make a successful transition to the new lease accounting standard.

Executive Counsel: At the executive level, an unbiased consultant with Big Four experience can help senior management understand the “big picture” potential impact of future rules on the way the company is doing business now. Specifically, they can prepare a pro forma report showing how the company’s present leasing practices will affect their balance sheet under the new rules and offering advice on how to make the rules less impactful – up to and including changing the company’s leasing strategy. More broadly, consultants can use their wide purview to give executives insight into how their industry at large is approaching the new rules.

Accounting Competency: While most companies have sound processes for tracking big-ticket leases, few have dedicated resources to monitor their possibly myriad small leases. To be ready for implementation, companies need to implement procedures and controls now to improve the recording, accounting and tracking of all leases. That said, upgrading the competency of any department needs professional oversight. A seasoned consultant with lease accounting expertise can put best-of-breed processes in place to identify and inventory all current leases, ensure proper accounting today for future compliance and provide a blueprint for future leases. And, they can do it quickly and efficiently.

Procurement and Facilities Competency: A consultant with deep lease accounting experience can also help non-accounting departments upgrade their understanding of new rules and implement best practices to enable coordination and collaboration with the accounting function.

Although the implementation of the new lease accounting rules may not be required until perhaps 2012, companies need to keep in mind that the new rules will affect all leases in existence on the implementation date. Given the enormous importance leasing plays in most companies’ strategic plans and the amount of work required to reclassify and re-record current leases, we at Blythe Global recommend getting ready now.

If you missed my April 2010 newsletter discussing the new converged rules for revenue recognition, [click here to read it now](#).

To discuss this important topic further,
contact marc@blytheglobal.com

Here's a sample of the services we are currently providing to several clients.

- Assisting public companies with technical accounting and financial reports for SEC compliance.
- Providing litigation support to accounting expert witnesses for a litigation involving alleged fraud.
- Assisting companies on the buy side to establish procedures to manage the M&A process, including helping to build due diligence and integration checklists.
- Providing companies with risk-assessment services in connection with Sarbanes-Oxley compliance.

To learn more about Blythe Global Advisors and our solutions,
visit our web site at www.blytheglobal.com or call 949-757-4180

About Marc Blythe



As president of Blythe Global Advisors, Marc Blythe brings more than 20 years' experience advising companies of all sizes across all industries on their accounting and financial reporting requirements. His areas of expertise include revenue recognition, equity compensation, mergers and acquisitions/purchase accounting, restructurings/impairments, consolidations, lease accounting, derivatives and debt. Prior to forming Blythe Global Advisors, Marc was an audit partner at Ernst & Young.