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Leasing: Changing accounting rules shouldn't mean changing strategy

Recent proposals will mean more transparency for investors—but won't change how companies operate and create value.

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When the US and international accounting-standards boards published a draft of their new lease-accounting rules last summer, they defined the move as a significant post-financial-crisis change that would increase transparency for investors.[1] In theory, they're right. Gone would be the distinction between operating and capital leases. Instead, companies would need to account on their balance sheets for every material asset they have the right to use and to include depreciation for those assets on their income statements.

Like other regulatory changes in the wake of the recent financial crisis, these have spurred lively debate among accountants and analysts. Indeed, in March 2011 there were some indications that the US Financial Accounting Standards Board (FASB) may have had a change of heart and decided to adopt something closer to the old rules.[2] Amid all these discussions, executives should remember that the implications for the value of individual companies are minimal. Companies might need to provide investors with more details on assumptions for specific leases and may have to amend some debt covenants and compensation contracts to account for mechanical changes in earnings before interest, taxes, depreciation, and amortization (EBITDA) and interest payments. But none of the changes that stem from the originally proposed new accounting rules for leases will make any difference to a company's cash flows or to how it operates and creates value.

For executives—particularly in industries with extensive leasing portfolios, such as retailing and transportation—the message is clear: these changes in accounting rules, by themselves, warrant no shift of real-estate or financing strategies. As we've outlined in earlier research, accounting-rule changes that do not require companies to disclose more information don't bring forth new insights that might lead investors to change their assessments of a company's value.[3] In this case, investors are well aware of, and closely track, leasing liabilities, which have long been outlined in balance sheet footnotes.

The rules may change . . .

At a high level, the originally proposed change in rules would mean two things for a company's accounting practices. First, accountants would need to recognize, on their balance sheets, a liability for future lease payments over the initial lease period, as well as any likely lease extension.[4] That liability would be amortized over time and, much like a mortgage, would not decline in equal parts over the life of the lease.

Second, companies would need to put on their balance sheets the value of the right to use an asset. Initially, this value would equal the liability. The asset, however, would have to be reported using straight-line amortization, declining in equal parts over the life of the lease. Consequently, the liability would always be larger than the asset.

The effect of these two rules would be an increase in EBITDA, the reported depreciation, and the reported interest expense, as well as a longer balance sheet. Because of the mismatch between liability and asset, shareholder equity would also change.

These proposed rules would affect any company that leases property or equipment. But they will most affect companies in sectors that rely heavily on leases, such as retailing, which traditionally leases large amounts of real estate. A company's net reported property, plant, and equipment (PP&E) numbers, which would include leased assets, could increase from 30 to 60 percent, depending on the subsector. Reported long-term debt would similarly increase by the amount of the lease liability, and reported EBITDA would go up by 30 to 40 percent[5] because the lease payment would become an interest and amortization expense.

. . . but the economics will stay the same

As with any proposed rule change, the comment period prior to this one has raised many questions. Executives at some companies are wondering whether equity valuations or debt capacity will change under the proposed rules as reported leverage goes up and EBITDA interest coverage goes down. If so, some are asking whether they need to rethink their target leverage or debt levels—or even revise their asset ownership strategies, given the significant impact of the proposed rules on the balance sheet.

Yet no strategic changes should be necessary; only accounting practices should change. Even among companies whose balance sheets and income statements would be most affected by the proposed rules, cash flows will change only if executives alter their strategic decisions simply because of new accounting rules. Otherwise, little is likely to change. Let's consider the impact in three areas: valuation levels, underlying debt capacity, and ownership strategy.

Valuation levels

Investors probably won't revalue companies, because under the proposed rules no material new information would be released. In the two sectors that account for most of the outstanding present value of lease liabilities—retailing and transportation (exhibit)—investors and financial analysts already have decades of experience making adjustments for the impact of off-balance-sheet operating leases. They've grown quite adept at using metrics such as earnings before interest, taxes, depreciation, amortization, and rent (EBITDAR) to assess corporate profitability, so even though

Exhibit

The impact of debt from leases is fairly concentrated.

Estimates for US companies with >$100 million in market capitalization

Top 3 by change after adjustment

	Distribution of lease debt, % (100% = $1.1 trillion)	**Average ratio of debt to total value,**[1] %		
		Unadjusted for lease debt	Adjusted for lease debt	Change after adjustment, percentage points
Nonfood retailing	18	20	40	20
Transportation	10	39	50	11
Energy	9	25	29	4
Food and staples retailing	8	22	34	12
Capital goods	7	46	48	2
Software and services	7	12	17	5
Telecommunication services	7	50	55	5
Consumer services	5	33	40	7
Health care equipment and services	5	25	31	5
Media	5	44	48	4
Technology hardware and equipment	4	10	14	4
Consumer durables and apparel	3	28	36	8
Food, beverage, and tobacco	3	22	24	2
Materials	3	33	36	3
Commercial and professional services	2	43	48	5
Pharmaceuticals, biotechnology, and life sciences	2	19	21	2
Automobiles and components	1	72	73	1
Household and personal products	1	20	22	2
Semiconductors and semiconductor equipment	1	10	12	2
Utilities	<1	~59	~59	<1

[1]Includes financial debt, minority interest, preferred stock, and net pension and other post-employment-benefits liabilities at book value.

adjusting market-based leverage ratios for leases raises the average debt-to-value ratio by 10 to 20 percent, they're unlikely to change their views about the value of these companies. In other sectors, while reported debt might increase—even significantly—the impact is negligible compared with total market capitalization. Even investors who do not understand this transparent change in reported numbers are unlikely to revalue these companies.

Underlying debt capacity

Cash flows and asset values will remain exactly as before, so debt capacity will not change—even if the reported leverage and interest coverage ratios do. These changes could potentially violate some simple debt covenants, but since many covenants already include adjustments for lease payments, it's unlikely that even companies with these arrangements would encounter difficulties. If a debt covenant has been defined solely on generally accepted accounting principles, without any adjustment clause, the change is so obvious that lenders and borrowers could easily bridge the numbers and append the original agreement.

It would be troubling if lenders used the change to pressure companies into completely new loan agreements. Given today's relatively low borrowing costs, however, an exit from existing debt clauses will probably be more beneficial than harmful.

Ownership strategy

The only factors that should influence a company's decision to lease or own equipment or property should be those that change the company's underlying fundamentals. These include the net-present-value impact of cash flows, the value of the flexibility that comes with shorter-term leases, alternate uses for the assets (decreasing the cost of a lease), and their strategic importance. The proposed accounting-rule changes would alter none of these, so a well-planned asset ownership strategy does not need to change. ○

[1] The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board proposed new rules to FASB 13, which governs lease accounting. They are expected to be finalized in 2011 and to go into effect in 2013.

[2] As of the time of writing, in March 2011, the FASB has directed its staff to consider rules that would still keep two types of leases that look close to the old distinction between operating and capital leases.

[3] See Timothy Koller and Werner Rehm, "Why accounting rules shouldn't drive strategy," mckinseyquarterly.com, February 2007; and Timothy Koller, "Numbers investors can trust," mckinseyquarterly.com, August 2003.

[4] Executory costs (such as real-estate taxes, utilities, and landscaping) would be excluded from this liability and measured as a periodic expense even if they are included in the original lease terms.

[5] Source for estimates: *Issues and solutions for the retail and consumer goods industries*, PricewaterhouseCoopers, 2010.

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