An Avison Young Topical Report

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Private-equity investments will be impacted by FASB's changes to lease accounting

Cost reduction is one of the key driving forces in the investment strategy adopted by private-equity (PE) firms. In addition to reducing the cost of goods sold (COGS) and direct labor costs, lease expenses are an important component used by lessees to drive cost reductions. Hence, it is imperative for PE firms to understand the operational and financial implications of the recent lease accounting changes on their portfolio companies and how a real estate lease's structure can help or hurt profitability.[1]

Enterprise Value | **Shareholder Equity** | **Net Income**

The use of financial statement metrics by the PE firms, especially with respect to the balance sheet, will likely be impacted by the lease accounting changes. Key performance ratios, like the return on capital employed and leverage ratios, will dramatically change with the addition of assets and liabilities to the balance sheet. This change may trigger debt-covenant violations and compel creditors to demand answers to their questions regarding new balance sheet amounts. At this time, it is prudent for borrowers to proactively begin conversations with their creditors to review contract terms alongside their legal counsel.[2]

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

The New Lease Accounting Standard

FASB's new guidance, Accounting Standards Update (ASU) 2016-02, Topic 842 Leases, requires lessees to recognize most leases on their balance sheet as lease liabilities with a corresponding right-of-use asset.

"Lessee Accounting - The core principal of Topic 842 is that a lease should recognize the assets and liabilities that arise from all leases. All leases create an asset and a liability for the lessee in accordance with FASB concepts statement No. 6, Elements of Financial Statements, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and liabilities to be recognized for most leases."

EBITDA | **Regulatory Capital** | **Debt**

Effective Date

The Financial Accounting Standards Board (FASB) new lease accounting standard will take effect for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other organizations, the standard will take effect for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.

Real Estate Lease Structure

There are elements of real estate lease agreements that will minimize, or increase the impact on the financial statements and the overall success of a business. How you negotiate the financial terms and conditions of real estate leases will influence the results on the financial statements. PE firms need to understand that the rate structure of a real estate lease, concessions, operating expenses, improvement allowances, renewal and termination options will all play a role in cash flow, assets, liabilities and EBITDA. One of the biggest changes in the new standard is the treatment of a sale-leaseback. Under the old standard, the "leaseback" would not be recorded on the balance sheet. When the new standard goes into effect, the leaseback will be recorded on the balance sheet, and if the criteria is met for the transaction to be considered a sale, the lessee will recognize the gains, or losses—immediately rather than over the leaseback period.[3]

Lease Classification

The new standard will classify leases as either finance or operating leases. Operating leases will be capitalized onto the balance sheet with a right-of-use asset and a lease liability, and recorded on the income statement with a straight-line rent expense. Finance leases will also recognize a right-of-use asset and a lease liability, but will recognize amortization of the asset and interest on the liability. These lease classifications will be presented differently on the financial statements, influencing cash flow, balance sheet metrics, net income and EBITDA.[4]

How to Mitigate the Impact of New Lease Accounting Rules

Retain trained professionals, experienced in the updated FASB guidelines and how to structure lease obligations to minimize the updated guideline impact.

Re-examine the terms of existing leases before the new standards take effect.

Understand how the changes will impact financial statements.

Start planning now.

Immediate Action Required

The following actions when structuring and negotiating a real estate lease can protect or improve the enterprise value of a company.

1. Start now - hire an expert;
2. Complete a strategic review and analysis of existing leases under the new lease accounting standards; and
3. Understand and manage impacts on the financial statements BEFORE the lease is signed.

Conclusion

Private-equity firms must begin assessing the impact on their holding companies' real estate lease transactions. Companies may want to evaluate lease-versus-buy decisions and transition to negotiating terms and conditions within the real estate document that support their overall financial goals.

It is essential that PE firms and their portfolio companies engage real estate professionals experienced and educated as to how FASB updates will affect financial outcomes.

About the Author

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End Notes

1. Financial Accounting Standards Board, *ASC Topic 842 Leases*. [N.p] February 25, 2016, p. 7.

2. Deloitte. *Real Estate Spotlight: A walk-through of FASB's new leases standard*. Deloitte. [N.p] July 2016, p. 1.

3. Carlock Jr., Byron and Tom Wilkin. *The Overhaul of Lease Accounting: Catalyst for Change in Corporate Real Estate*. PricewaterhouseCoopers. [N.p] April 2016, p. 4.

4. Financial Accounting Standards Board, *ASC Topic 842 Leases*, pp. 30-31.