

The future of leasing

Research of impact on companies' financial ratios



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Research completed by PricewaterhouseCoopers and the Rotterdam School of Management, the Netherlands has quantified the impact of the proposal for lease accounting on financial ratios reported by 3,000 companies worldwide. The expected minimum impact of the proposed changes to lease accounting is that the reported interest bearing debt, leverage and EBITDA by companies will increase, for certain companies this increase will be substantial.

Summary of research results

In March 2009, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued a Discussion Paper proposing a new model that would significantly change lease accounting for lessees, including the elimination of operating leases. Under this proposal, the current distinction between operating leases and finance leases will be eliminated and all leases will be accounted for on balance including existing operating leases that are now accounted for off balance. The comment period for the Discussion Paper ended on July 17, 2009. 300 comment letters were received. Since then, the boards are evaluating the feedback received and expect to release an exposure draft in mid-2010 and a final standard in 2011.

Research completed by PricewaterhouseCoopers and the Rotterdam School of Management, the Netherlands has quantified the minimal impact of the proposal on financial ratios reported by companies worldwide. Based on the operating lease disclosures in financial statements of some 3,000 companies worldwide, they expect that the reported interest bearing debt of these companies will increase with an average of 58%. This is a cautious estimate as only the impact of capitalizing disclosed operating leases is quantified in the research. The impact on companies' debt can be higher depending on the specific details in a final standard. The average impact on debt balances is influenced by a number of companies that will see a large relative increase in debt. Nevertheless, 24% of the companies will see an increase in their debt balances of over 25% based on this research.

The research also shows that the impact on financial ratios differs significantly per industry. Industries that will see the highest impact on reported financial ratios are:

- Retail and Trade;
- Professional and Other services;
- Transport and Warehousing;
- Accommodation; and
- Telecom.

For retail companies, the reported debt balances are expected to increase by an average of 213% and the leverage (calculated as interest bearing debt divided by equity) will increase by an average of 64 percentage points. Approximately 71% of the retail companies will see an increase of reported debt balances of over 25%.

The following table includes a summary of the average impact per industry:

In % except for leverage	Average increase in interest bearing debt	% companies with over 25% increase	Average increase in leverage (percentage points)	Average increase in EBITDA
Retail and Trade	213	71	64	55
Other Services	51	35	34	25
Transportation and Warehousing	95	38	31	44
Telecom	23	21	20	16
Professional Services	158	52	19	27
Amusement	25	18	19	13
Accommodation	101	41	18	30
Wholesale Trade	34	28	17	21
All companies	58	24	13	18
Manufacturing	50	21	9	13
Construction	68	20	8	14
Oil, Gas and Mining	30	16	7	10
Financial services	27	11	6	15
Utilities	3	3	2	6

Certain companies have limited debt balances / low leverage. As a consequence the impact of capitalization of operating lease commitments has is relatively high. These outliers have a large impact on the calculation of the average increases for financial ratios. As a consequence, the medians are also reported below, as these are not influenced by the outliers:

In % except for leverage	Increase in interest bearing debt	Increase in leverage (percentage points) <i>Median¹</i>	Increase in EBITDA
Retail and Trade	64	42	34
Other Services	16	17	13
Professional Services	28	12	20
Transportation and Warehousing	14	9	14
Telecom	9	8	7
Wholesale Trade	13	8	11
Accommodation	12	6	10
Manufacturing	9	5	7
All companies	8	4	7
Construction	3	4	6
Amusement	5	4	5
Financial services	3	2	5
Oil, Gas and Mining	3	1	2
Utilities	0	0	3

¹ This means that 50% of the companies have a higher impact and 50% a lower impact. The median is less influenced by outliers than the average.

The research also shows that the impact on individual companies within an industry can be significantly different depending on the size of the company and country of residence. Companies in the Netherlands are expected to see an average increase in leverage of 27 percentage points which is the largest increase. This may result in a competitive disadvantage for companies in the Netherlands compared to their peers in other countries.

The following table includes the average increases for a selection of key countries:

In % except for leverage	Average increase in interest bearing debt	% Companies with more than 25% increase	Average increase in leverage (percentage points)	Average increase in EBITDA 2008
Netherlands	111	35	27	27
United Kingdom	110	42	20	24
Italy	42	18	20	30
France	27	36	20	31
Sweden	68	33	17	21
Germany	84	33	16	18
United States	34	19	15	15
All companies	58	24	13	18
Switzerland	100	34	12	28
Singapore	48	28	8	20
Hong Kong	75	19	7	18
China	41	18	5	13
Japan	187	19	2	30

In the following table the median is presented for the increases per country. This median is less influenced by outliers than the average:

In % except for leverage	Increase in interest bearing debt	Increase in leverage (percentage points)	Increase in EBITDA 2008
	<i>Median ²</i>		
Netherlands	16	12	12
France	18	10	22
United Kingdom	19	9	11
Sweden	11	7	12
Germany	12	5	10
United States	7	5	7
Switzerland	15	4	10
All countries	8	4	7
Italy	4	4	11
Singapore	9	3	7
Hong Kong	3	1	4
Japan	3	1	14
China	2	1	2

² This means that 50% of the companies have a higher impact and 50% a lower impact. The median is less influenced by outliers than the average.

The proposal will also result in an increase of EBITDA (Earnings Before Interest Tax Depreciation and Amortization). EBITDA is expected to increase as rent expense will be replaced with interest and amortization expense, which are below-the-line charges. The companies in the research will see an average increase in EBITDA of 18%. For companies in the Netherlands this advantage is slightly higher and amounts to 27%. The economic downturn resulted in a lower 2008 EBITDA for many companies. As a result, this increase in EBITDA might not be representative for the actual increase upon a final standard.

Analysts, credit agencies and banks currently adjust financial statements for off balance operating leases using various rules of thumb. A frequently used rule of thumb to estimate the lease liability and to adjust financial statements is based on a multiple of 7 applied to the annual rent expense. This rule of thumb is based on an average remaining lease term of approximately 7 years. Whether this rule of thumb, as an approximation of the lease liability used to adjust financial statements for off balance operating leases, is reliable can only be concluded upon issuance of a final standard. Companies' stock prices and access to capital may be impacted if the conclusion is that the rule of thumb historically used was not reliable in estimating the actual adjustment to the financial statements.

The research compared the adjustment to companies' debt as a result of capitalization of off balance operating leases with the results of the rule of thumb. This comparison shows that for 93% of the companies the rule of thumb of 7 times the rent expense resulted in an overstatement of debt balances. However, the actual impact on financial ratios will depend on the details in a final standard for lease accounting.

The following table presents a summary of the percentage of companies per Industry for which the rule of thumb overstates the adjustment for capitalization of operating leases:

In %	% companies for which the lease liability is lower than rule of thumb of 7x rent expenses
Accommodation	22
Retail and Trade	15
Transportation and Warehousing	13
Oil, Gas and Mining	12
Financial services	11
Telecom	7
All companies	7
Construction	7
Other Services	6
Professional Services	5
Amusement	5
Wholesale Trade	5
Manufacturing	5
Utilities	5

A final standard may likely require lease capitalization based on a lease term that is longer than the contractual lease term (i.e. 'longest possible lease term that is more likely than not to occur'). This might tend to lengthen the accounting lease term beyond that determined under existing lease accounting standards. The resulting adjustment to financial ratios for off balance operating leases might be significantly higher under this approach to determining the accounting lease term. In this scenario, the adjustment to companies' debt will increase and may even be higher than the rule of thumb. Companies that will report a larger increase in debt than the rule of thumb applied by analysts, credit agencies and banks should be concerned, especially if their peers in the industry are not.

The financial industry generally acts as lessor. The economic benefits of leasing will not change as a result of the proposed lease accounting. Lessors will need to emphasize the continued economic benefits of leasing as well as address the potential practical consequences for lessees.

Contacts

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Appendix I – Summary of research approach

The research is based on the 2008 financial statements of over 3,000 listed companies in 54 countries worldwide. Companies with a negative equity or companies with a market cap of less than USD 50 million were excluded from the research. Also, the outliers for the most important variables are excluded. After this exercise a dataset remains for 2,795 companies.

The disclosures in the financial statements include the operating lease commitments for minimum lease payments. The operating lease commitments are generally disclosed in a first year lease commitment, lease commitment for the years 2-5 and lease commitment after 5 years. On the basis of these disclosures in the financial statements and certain assumptions, an allocation of lease payments was performed to individual years. These annual lease payments were subsequently discounted. The discount rate applied was a company's incremental borrowing rate taking into account a company's credit rating. If a credit rating was not available, the discount rate used was the industry average.

The increase in interest bearing debt is determined using the calculated lease liabilities for off balance operating leases and their relative impact on interest bearing debt.

Leverage was defined as interest bearing debt divided by equity. The calculated increase in lease liabilities was used to determine the increase in leverage presented in percentage points.

The increase in EBITDA was determined by adding back the disclosed rent expenses. In instances where these were not disclosed separately, the annual rent expense is approximated with reference to the disclosed first year operating lease commitments.