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CFA Trending Topics

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Upcoming changes in lease and accounting treatments

Key takeaways:

- New U.S. GAAP and IFRS leasing standards will soon put most operating leases on the balance sheet.
- For most U.S. GAAP companies, the new U.S. standard (ASC 842) will not change the income statement, but will involve additional work, beginning with establishing the discount rates at which to capitalize operating leases.
- For IFRS companies, the new standard (IFRS 16) will change the income statement and could affect important metrics.
- Please feel free to reach out to the Corporate Finance Advisory team should you have specific questions as it relates to the new leasing standards.

The following provides a high-level overview of the impending changes to lease accounting, and includes key similarities and differences between ASC 842 and IFRS 16:

1. Both standards are effective for public companies for fiscal years beginning after 12/15/2018; in addition, U.S. GAAP now corresponds to IFRS treatment by referring to capital leases as finance leases.
2. In contrast to IFRS, U.S. GAAP preserves the straightline income statement treatment of operating leases, while IFRS 16 requires all on-balance sheet leases to be treated as finance leases on both the balance sheet and income statement.
   a. For IFRS companies, this could change important metrics and could require time and effort to educate analysts.
   b. In contrast, U.S. Companies will not need to spend time or effort educating analysts unless unusual metrics are used in measuring performance, such as "return on assets," which is not common.
3. Both U.S. GAAP and IFRS create certain scope exceptions where leases can avoid being capitalized on the balance sheet:
   a. Under both ASC 842 and IFRS 16, leases for a period of a year or less (as long as renewal isn't reasonably certain to occur) will not be capitalized.
   b. Under IFRS 16, "small ticket" (currently defined as those having a "low value," (i.e., of

$5,000 or less)) leases will not be capitalized.

4. All on-balance sheet leases will be capitalized with a liability (the present value of lease payments), initially balanced by a right-of-use asset.
5. If either operating or finance lease obligations are material for U.S. GAAP companies, either obligation cannot be combined with the other but must be separately presented on the balance sheet.
    a. Obligations under finance leases would be excluded from debt, unless immaterial.
    b. In contrast, obligations under operating leases would never be included in debt, even if immaterial, when they would likely be included in other liabilities.
6. U.S. companies will need to examine - and amend as needed - all credit agreements, so that it is clear that capitalized operating lease obligations will not be included in the definition of indebtedness, unlike finance leases.

Both standards modify slightly the definition of what constitutes a lease, which in general is expected to result in fewer contracts meeting the definition of containing a lease.