

The New US GAAP Lease Requirements and the Impact on Financial Ratios

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- Current Lease rules US GAAP ASU 840
- Proposed-new lease rules ASU 812
- Effective date for public companies after 12/15/2018 year end. All others after December 31, 2019

Lease overview

Lease

Lessor

Lessee

Lease payments

Lease terms

Types of leases-lessee

- Operating—rent expense. Off balance Sheet
- Capital/ Financing –Balance Sheet
- Goal: OFF BALANCE SHEET DEBT
- Better for financial reporting and lease requirements
- Bond and other covenants

CURRENT US GAAP Lease requirements-Lessee

- Capital lease if meet 1 of 4 requirements
- 1-Transfer of title
- 2-Bargain purchase option
- 3-Economic use-lease term greater or equal to 75% of economic useful life of asset
- 4-Economic benefit-if PV of minimum lease payments is equal or greater than 90% of fair value of asset

Interest rate used

- The interest rate to use:
- Incremental borrowing rate or implicit interest rate if known and is lower.

Implications

- Teats 3 and 4 are flexible and not exact. Thus, companies circumvent the rules to result in an operating type-off balance sheet lease result.
- Over \$4 billion of off balance sheet debt in US in 2017.
- Off balance sheet debt is a type of low level misrepresentation of financial reporting. Balance sheet not inclusive.

Implications

- Assets understated but most importantly—
Liabilities-current and long term understated.
Goal of companies—no debt.
- Debt is dangerous and may force prepayments
of debt; higher interest costs; limited
borrowing capacity—result: Higher cost of
capital and lower company value.

History

- Current rules 840 –since 1978. Incredible that it lasted so long, especially as leases are the biggest culprit of SEC restatements.
- Has been debated for over 40 years.
- Enron-off balance sheet debt resulted in their bankruptcy.

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- New rules
- All non-cancellable leases greater than 1 year need to be put on the balance sheet—finance leases. 2 types of leases: Type A and Type B
- 1 year or less-choice-can put on balance sheet or keep off balance sheet.

Type A

- If meet 1 of 4 tests before or 5th test-Lessor has no economic benefit---Type A;
- Otherwise Type B.
- Both put on Balance Sheet.
- Interest rate
- Incremental borrowing, implicit or risk free rate

Type A

- Accelerated method
- Expense = Amortization plus interest.
- PV of lease payments.
- If option to renew lease –included if probable that renewal will be exercised.
- Asset-Part of property, Plant and Equipment-separate classification called: Type A Lease
- less: Accumulated Amortization

Other statements

- On Income Statement-Amortization plus interest expense
- On cash flow statement-interest paid and reduction of lease liability-CFF

Type B

- On Balance Sheet at PV-Asset and Liability; current and long term..
- Asset: Separate classification of PPE-Lease-Type B less Accumulated Amortization.
- Equal expense each year-called rent expense.
- Cash flow-operating cash flows. Interest plus payment of lease liability.
- NOT REALLY ECONOMIC LIABILITIES

IMPACT OF 842

- Devastating.
- Much more current and long term liabilities
- Debt ratios-current, debt to capital, debt ratio, times interest earned are severely hurt.
- Harder to borrow-and costlier
- Debt covenants force prepayments

Recommendations

- Shorter lease terms
- Purchase with cash and don't borrow or lease
- Short term leases- when feasible
- Never use risk free rate to value leases