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.
• 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.
842

- 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 pit on balance sheet or keep off balance sheet.
Type A

• If meet 1 of 4 tests before or 5\textsuperscript{th} 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