

Lease Accounting

Common implementation challenges.

Lease accounting: An introductory guide for finance departments.

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In 2016, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued new directives on how issuers should account for and disclose operating leases on their financial statements. The aim of these new standards was to provide investors with transparent and comparable information about all lease obligations. The resulting standards are known as the Accounting Standard Codification (ASC) 842 and the International Financial Reporting Standard (IFRS) 16.

While the accounting treatment of leases on the balance sheet and income statement may differ between the two standards¹, they share one common characteristic - the determination process of the incremental borrowing rate (IBR).

ASC 842 became a reality on Jan 1, 2019, for all public companies reporting under US GAAP however, not surprisingly, its implementation was far from trouble-free. The challenges encountered resulted in FASB having to delay the implementation timeline for private companies by an additional year—until the beginning of 2020. As we are getting closer to the new implementation timeline, and private companies are in the midst of preparation to adopt the new standard, this article aims to share some common mistakes we encountered with their public counterparts.

It is important to note that, while the new accounting standard brings a whole slew of new disclosure requirements for the lessee, the lessor accounting remains almost unchanged from the legacy US GAAP (Topic 840). Topic 842, which affects the lessees, does not discriminate between asset types and it covers all leases including real estate, production equipment, technology, fleet and automobiles, etc.

Impact of the new rules

The impact of the new rules is felt globally. Subsequent to ASC 842 and IFRS 16, similar rules were adopted in many countries around the world with similar implementation periods (2020-2022). For example Australia adopted AASB16 with an implementation period of 2019-2020, Japan adopted ASBJ16 (2019-2022), China CAS 21 (2019-2021), etc. This further illustrates the need for a global, consistent and defensible approach to determine the incremental borrowing rates (IBRs).

¹ ASC 842 maintains the dual accounting model. On the balance sheet operating leases are treated the same way as finance leases. However, on the income statement the operating lease cost continues to be a straight-line recognition of total lease expense (i.e. rental expenses). On the other hand, IFRS 16 requires a single accounting model for leases, with operating leases being treated the same way as finance leases.

As mentioned before, the adoption of the ASC842 for public companies in 2019 has largely been considered a failure, and this is one of the reasons why the adoption date for the public companies has been delayed by an additional year. One of the key challenging aspects of the new accounting standard is the process around determination of a company specific lease discount rate. When filing 10Ks and 10Qs, lessees are required to fully disclose the process as well as all assumptions or adjustments made during the determination of the IBRs. Herein lies the challenge - for companies with a global presence, the IBR process must be transparent and consistent across geographies. This sounds logical, yet the practical application is not straightforward, due to an asymmetry of available data. For entities based in the US and EU zone, obtaining underlying data is relatively easy, but once we look outside of these two regions, even in places with developed markets such as Canada, UK or Australia, we are quickly faced with data availability constraints resulting in the need for additional assumptions and adjustments.

In this article, we will attempt to share the most common adoption challenges and questions we are facing while our clients are preparing their 10Ks and 10Qs filings.

Frequently asked questions

What are the adoption dates?

Public business entities adopted Topic 842 for interim and annual periods in fiscal years beginning after Jan 1, 2019. All other for-profit entities will apply Topic 842 for annual periods in fiscal years beginning after December 15, 2020, and interim periods in fiscal years beginning one year later in 2021.

How is the IBR determined?

Topic ASC 842 provides little specific guidance on how to determine Incremental Borrowing Rates (IBR):

The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term, or an amount equal to the lease payments in a similar economic environment.

Which leases are covered?

It is not unusual for a large corporation to have hundreds, if not thousands of leases. These frequently involve not only real estate, but also production or IT equipment, automobiles, and other industry-specific leased items. Lessees with operating leases will thus increase their reported assets and liabilities, sometimes significantly. The effect on lessees is direct, affecting investor and analyst expectations and potentially the compliance with contractual debt covenants.

Key points of guidance

Given how little information is provided in terms of guidance, here are some of the key points to be addressed:

Collateralization

One of the key new features of the accounting rules and a departure from the old accounting standard is the requirement to apply a "secure rate." This requirement could easily be answered by an entity when a secured or "collateralized" debt is issued, however, the answer is not so obvious when an entity and its peers have issued only unsecured debt. To understand this challenge, we looked at all the bonds issued by US entities in the 2019 (11K) and discovered that only 306 (less than 3%) of them we secured.

Corporate credit rating

Another key component in the IBR analysis is the credit spread reflective of the credit standing of the lessee. Generally, there is inverse relationship between rating and the level of interest rates charged-the higher the rating, the lower the rate and vice-versa. The level of interest charged here compensates the lender (the lessor) for the risk of default of the borrower (the lessee). The lower the rating of the lessee, the higher the probability of the default, thus, the higher the interest rate asked by the lender. This process is fairly transparent and works well for publicly rated entities, especially the ones with investment grade rating. For the entities rated high-yield or lower, the market quickly becomes opaque and less transparent. One can imagine that in the case of non-rated entities, this issue is even larger. In such instances, an implied credit rating or score could be the solution. However, this requires a deep understanding and experience in analysis balances-sheets and infers a short-term and long-term ability to serve liabilities, a free cash-flow analysis, access to borrowing and payment history, and default history as well as exposure to political or country risk. These are not skills everyone has or develops overnight.

Subsidiary vs. parent

In most cases, the parent entity might already have an observable or indicative credit rating, but subsidiaries rarely do. This poses yet another challenge: should we determine an IBR per subsidiary or under what conditions can the subsidiary use the parent's IBRs? When faced with this challenge, FASB did not oppose the latter option and it offered two separate cases where this is applicable: a) a consolidated entity, where the parent provides payment guarantees and b) treasury centralization, where leases would be priced by the central treasury, rather than by the entity entering the lease. In both cases, FASB determined that using parent's or central treasury IBR is appropriate.

Length of the lease obligation

Another key component in the analysis is the length of the lease. If the lease term differs from the term of the reference borrowing (e.g. a 3-year lease term compared to a 7- or 10-year note), the IBR should be adjusted to reflect the effect on the rate of the different term.

Risk free rates

Risk free rates may or may not be part of the analysis, depending on whether the analysis is done on spread to risk free rate, or on a gross-yield basis. Regardless of the approach, the risk free rate is reflective of the economic environment (country risk) where the lease transaction takes place. Clearly, prevailing interest rates and other borrowing costs in one country or region may not be the same as those in another country or region. This is particularly evident when considering leases in the EU zone. A lease based in Italy would command a very different rate than a similar lease in Germany, even when both are priced in the same currency (EUR).

Cost of funds be used in-lieu of IBRs

When asked if "cost-of-money" is a good proxy for the IBR, FASB rejected the view that it is a good proxy and it would be an appropriate discount rate for lessees. The Board believes that it would be different than the rate a lessor would charge for a lease.

Common issues

What are the common issues when applying the guidance?

Using outdated or stale credit spread information

One of the most common mistakes we come across is related to the use of stale or rarely updated credit spread information such as a static CDS spread, historic term loan spreads, or revolver spreads, etc. Credit markets are very dynamic markets. On very rare occasions, even in benign markets, one will see flat or unchanged levels. In the current and volatile markets, similar to the ones we have been experiencing in the latter part of 2019 and early part of 2020. For example, take a look at change of spreads BBB composite experienced between December 31, 2019 and March 31, 2020.



As the image to the left shows, the US fixed income market is the deepest fixed income market and offers great daily transparency, thus it is hardly justifiable to use stale or outdated information when such data is abundant.

Securitization adjustment

Different companies have taken different approaches to determine the "secured" IBR rate adjustment. Some are using notching while others are applying constant spread, or a full-term structure of spread adjustment. While all of them are defensible in the context of a single currency IBR, their unadjusted use for foreign currency, or synthetic IBRs, is inappropriate. For example, a 25bps adjustment for USD rates at point of time is not equal to 25bps in EUR, CHF, GBP or CNY terms. In fact, these could be very different from an assumed 25bps, and thus result in wildly different and incorrect results.

Name:		My Config		Conversion Type:		Float -> Float			
Spreads (bp) in:		USD		Frequency:		Qtrly			
Convert to spreads (bp) by currency									
Term	USD	CAD	EUR	CHF	AUD	CNY	INR	TRY	AUD
3 MO	25.00	14.02	65.08	22.63	127.34	53.42	773.34	1160.92	127.34
6 MO	25.00	11.32	34.59	22.50	92.34	30.89	422.19	849.35	92.34
1 YR	25.00	4.03	14.68	22.32	65.72	5.66	226.83	621.24	65.72
2 YR	25.00	5.81	7.59	13.83	54.75	10.45	185.89	375.95	54.75
3 YR	25.00	7.88	4.02	7.08	51.41	0.78	167.11	260.27	51.41
4 YR	25.00	9.48	0.79	3.01	49.71	-6.82	146.07	193.25	49.71
5 YR	25.00	11.35	-1.59	0.49	49.02	14.69	123.61	168.34	49.02
6 YR	25.00	11.83	-2.46	-2.07	49.22	-5.32	115.34	152.49	49.22
7 YR	25.00	12.31	-3.59	-2.39	50.07	-21.62	111.57	138.18	50.07
8 YR	25.00	12.50	-3.85	-3.95	51.06	-31.37	101.34	124.16	51.06
9 YR	25.00	12.69	-3.98	-7.51	51.32	-39.55	94.29	115.38	51.32
10 YR	25.00	14.63	-3.98	-9.06	52.58	-46.44	89.01	113.65	52.58
04/08/3									
04/08/4									
Frequency		Qtrly	Qtrly	Qtrly	Qtrly	Qtrly	Qtrly	Qtrly	Qtrly

The conversion table shows that there is not a single instance where 25bps spread equates across regions.

Constant spread between multi-currency tranches

This is a less prevalent assumption, and it is typically present when the IBR analysis is based on existing multi-currency revolvers. The issue here is the same as described in the section immediately above.

Ignoring cross-currency basis

In a perfect world without restrictions of capital flows, we would be in the presence of "interest rate parity." This is a theoretical equilibrium where the interest rate differential between two countries is offset by the currency exchange on the spot and the forward market. Yet, we are not living in a perfect world and thus, the interest rate differential is real and not fully eliminated by the FX market. This results in a "currency basis." The basis is critical when performing the transitions in the two sections above. If completely ignored, then the calculations will inadvertently be incorrect.

Mix and match USD spreads with locally denominated interest rate benchmarks

As we discussed above, not all markets are created equal. As a result, some markets offer plenitude of information while others not so much. The latter scarcity of data resulted (results?) in mix and matching of data points with different units or currencies. For example, CDS spreads, quoted in USD or EUR applied to local currency government yield, etc.

Conclusion

The new lease accounting standards were conceived with the intention to provide transparency and comparability. Yet, the lack of clear guidance as to how to address lack of data in certain markets, led to large inconsistencies in the implementations. We are hoping that this paper, along with many others will provide additional guidance on how to overcome common challenges and result in less diverse disclosures, thus getting closer to the originally intended goal.

Bloomberg offers a global, transparent and audit-proof IBR solution. Please contact your Bloomberg representative or Yon Valtchev, the author of this article, at yvaltchev7@bloomberg.net for further information.

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Sydney
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