Lease Accounting: Operating Leases, Finance Leases, and the Confusing, Changing Rules

How to Confound Entire Industries with One “Simple” Change
We published a video a few years ago on the move to put Operating Leases on companies’ Balance Sheets as Right-of-Use Assets and Lease Liabilities...

...but there’s still a lot of confusion over lease accounting on the financial statements.
The **main issue** with this topic is that **in the abstract** (i.e., interview questions), it can be quite confusing...

...but **in reality** (models and valuations for real companies), it’s simpler because you never work with individual leases.
Lease Accounting: The Short Version

- **Basic Idea:** Under the rules now in place, companies treat all (OK, “most”) **leased assets** as if they *had purchased those assets using debt*

- **So:** When the lease is first signed, companies record a “Right-of-Use” (ROU) Asset and a corresponding Lease Liability on the L&E side of the Balance Sheet

- **Cash Reality:** Company then pays the agreed-upon annual payment in cash for this lease each year

- **Accounting Zone:** Company calculates Interest, Depreciation, and Principal Repayments for this “lease”
**Lease Accounting: The Short Version**

- **IFRS / Non-U.S. Companies:** The Depreciation stays constant, the Interest and Principal Repayments change, and the ROU Asset and Lease Liability both decrease, reaching $0 at the end of the lease term.

- **U.S. GAAP / U.S. Companies:** *Finance Leases* follow this same treatment, but *Operating Leases* are different – companies record a simple “Rental Expense” on the Income Statement...

- **But:** They *still* reduce their ROU Assets and Lease Liabilities each year via Depreciation & Principal Repayments...

- **What?:** But they don’t *show these* numbers or calculations on the statements!
Outline for This Tutorial:

• **Part 1:** Operating Leases vs. Finance Leases (Capital Leases)  4:41

• **Part 2:** Finance Leases and Operating Leases Under IFRS  6:04

• **Part 3:** The U.S. GAAP Treatment of Operating Leases  10:29

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Part 1: Operating Leases vs. Finance Leases

- **Operating Lease:** Company signs a contract to rent a building for $20 per year for 10 years, and it returns the building to the owner (the lessor) at the end.

- **Finance Lease:** The same terms but at the end, there may be an “ownership transfer” option or a “bargain purchase” option, so there is the potential for **ownership**.

- **Technical Criteria:** May classify as a Finance Lease if the Lease’s term exceeds 75% of the asset’s useful life, or if the PV of Lease Payments exceed 90% of the asset’s fair market value, or others...
Part 2: IFRS Treatment of All Leases

- **Scenario:** Same 10-year lease with $20 of rent per year, paid in cash each year

- **New Lease Signed:** Lease Asset and Lease Liability should increase by about the same amount

- **Initial Lease Asset and Lease Liability:** PV of the $20 of rent per year for 10 years at an “appropriate discount rate” (often in the 4-6% range; we’ll say 5% here)

- **Then:** Each year after that, the company records components for “Interest” and “Depreciation” and “Principal Repayments” based on the following...
Part 2: IFRS Treatment of All Leases

• **Interest:** Discount Rate * Lease Liability, so 5% * $154 initially

• **Depreciation:** Initial Lease Asset / Lease Term, so $154 / 10 = $15.4 per year over all 10 years

• **Lease Principal Repayment:** Appears on the Cash Flow Statement and is equal to the Cash Lease Expense minus the Interest Expense each year

• **So:** The Interest will keep *decreasing*, and the Lease Principal Repayment will keep *increasing*, but they’ll always add up to the same total – the Cash Lease Expense of $20!
Part 3: U.S. GAAP for Operating Leases

• **Finance Leases:** Follow the IFRS treatment – only *Operating Leases* differ under U.S. GAAP

• **Initially:** Operating Lease Assets and Lease Liabilities are created based on the same rules...

• **But:** The company simply records the $20 as a “Rental Expense” on the Income Statement in this case

• **Tricky:** “Off the financial statements,” the company still calculates Interest, Depreciation, and Principal Repayments!

• **But:** The rules are slightly different, and the Lease Assets and Lease Liabilities change at different rates
Part 3: U.S. GAAP for Operating Leases

• **Interest**: Discount Rate * Lease Liability, so 5% * $154 initially

• **Depreciation or Amortization**: Cash Lease Payment This Year Minus Interest This Year for leases with constant payments

• **Lease Principal Repayment**: Equal to the Depreciation or Amortization each year

• **So**: Under U.S. GAAP, the Lease Asset and Lease Liability *should decrease by about the same amount each year*, and the company records these numbers as “Changes in Lease Assets and Liabilities” on the CFS, offsetting each other
Part 4: Leases on the 3 Statements

• **Real Life:** It’s easier because real companies have *large portfolios of leases* (and Finance Leases tend to be small – focus on Operating Leases in models)

• **So:** If a company is *growing*, make sure that its Lease Assets, Lease Liabilities, and Total Lease Expense grow in-line with revenue each year

• **U.S. GAAP:** Make Op. Lease Assets a % of SG&A or Operating Expenses and make Op. Lease Liabilities grow by the same amount as Op. Lease Assets each year

• **IFRS:** Link Lease Interest, Lease Depreciation, and Principal Repayments to OpEx or Revenue or per-unit figures, such as the # of buildings the company is leasing
Part 4: Leases on the 3 Statements

• **IFRS:** Also need to include “Additions to Right-of-Use Assets” and “Additions to Lease Liabilities” on the CFS so that Lease Assets and Liabilities both *grow* as the company grows.

• **And:** We’d strongly suggest keeping these items separate from *normal* Depreciation, Interest, Debt Principal Repayments, etc.
Part 5: Valuation Impact – Multiples

• **Key Question #1:** Should you add Finance Leases and Operating Leases when calculating Enterprise Value? Just one? Both? Neither?

• **Key Question #2:** How do Leases affect the traditional DCF analysis to value companies?

• **Answer #1:** Under IFRS, it’s easiest to add all types of Leases when moving from Equity Value to Enterprise Value *in order to calculate valuation multiples*

• **Why:** Metrics like EBITDA already exclude the full Lease Expense (Lease Interest + Lease Depreciation ~ Full Expense)
Part 5: Valuation Impact – Multiples

• **U.S. GAAP**: Add Finance Leases to TEV because EBITDA excludes the full Finance Lease Expense, but do *not* add Operating Leases

• **Operating Leases**: Issue is that metrics such as EBITDA *deduct* the entire Operating Lease Expense under U.S. GAAP...

• **So**: For consistency, the numerator, Enterprise Value, should *not* add the corresponding Lease Liability

• **Alternative**: If you do add Operating Leases, you’ll have to use metrics like EBITDAR that add back the full Rental Expense
Part 5: Valuation Impact – DCF

- **DCF Impact:** It’s easiest to deduct the full Lease Expense for companies under both accounting systems.

- **Why:** A DCF should be based on *cash flows*, and the Cash Lease Payments represent *cash outflows* – splitting them into Interest, Depreciation, etc. doesn’t change that!

- **But:** The problem is that Unlevered Free Cash Flow normally starts with EBIT, or Operating Income.

- **And:** EBIT deducts only *part of* the Full Lease Expense (the Depreciation) under both accounting systems!
Part 5: Valuation Impact – DCF

• **U.S. GAAP**: EBIT deducts the full Operating Lease Expense, but only the Finance Lease Depreciation

• **So**: Easiest solution is to deduct the Finance Lease Interest and then *not add back* the Finance Lease Depreciation in the non-cash adjustments

• **But**: Many people just ignore these adjustments because Finance Leases are small and may not be disclosed separately, so it’s not that important (we rarely adjust)
Part 5: Valuation Impact – DCF

• **IFRS**: Also requires an adjustment because EBIT deducts only *part of* the Op. Lease Expense and the Finance Lease Expense.

• **Easiest**: Start with EBIT and deduct the Total Lease Interest before multiplying by (1 – Tax Rate) to get NOPAT.

• **Depreciation Add-Back**: Do *not* add back any Lease Depreciation! You *want* to fully deduct Lease Interest + Lease Depreciation in Unlevered FCF!

• **And Then**: Since you deduct the full Lease Expense in Unlevered Free Cash Flow, you should *not* count Leases at all in the Equity Value / Enterprise Value bridge.
Part 6: What About Interviews?

• **Truth:** You’re unlikely to get super-detailed / complex questions about lease accounting, in most cases...

• **Exceptions:** Some countries/regions are known for asking very technical questions (Germany), and if you have more experience, anything could happen

• **Recommendation:** Know the basics (Assets and Liabilities on the Balance Sheet and how they change over time)

• **But:** Doubtful that you’ll get multi-step interview questions about this topic (more of an on-the-job issue)
Recap and Summary

• **Part 1:** Operating Leases vs. Finance Leases (Capital Leases)

• **Part 2:** Finance Leases and Operating Leases Under IFRS

• **Part 3:** The U.S. GAAP Treatment of Operating Leases

• **Part 4:** Leases in Real Life in 3-Statement Models

• **Part 5:** Valuation Impact, Equity Value, and Enterprise Value

• **Part 6:** What Do You Need to Know for Interviews?