How Do the Provisions of Topic 842 Compare with IFRS 16 and what are the implications?
By Bill Bosco, Leasing 101

The lease accounting change project began as a joint project with an objective of converging on a worldwide set of rules. The idea of convergence was dropped when the FASB and IASB took different views on whether all leases were the same for lessee accounting. The FASB continued with the view that the economic characteristics of operating leases, based on a risks and rewards of ownership analysis, were significantly different from finance leases. As a result they maintained a two lease model with different accounting for the two lease types reflecting the differences. The two standards have been issued and the rules are not too far apart in most areas other than lessee accounting. The major objective of capitalizing most operating leases was achieved in both standards. This article will identify key differences (FASB ASU Topic 842 vs. IASB IFRS 16) that impact lessors and their structuring of leases to meet customer objectives and comment on the implications of the differences.

Lessee Accounting Model

IFRS 16 has a lessee recognition and measurement exemption for leases of assets with values of less than $5,000, while Topic 842 does not have a specific small ticket exemption.	***Commentary:*** *FASB ASC Topic 842 in the Basis for Conclusions (BC1) allows entities to adopt reasonable capitalization thresholds below which lease assets and liabilities are not recognized consistent with accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment). Small ticket lessors may wish to alert their lessee customers of this provision which could allow continued off balance sheet treatment of some small ticket leases.*

IFRS 16 considers all leases to be finance leases (formerly called capital leases) while Topic 842 maintains a 2 lease model where all leases are capitalized but operating leases created non-debt liabilities and the lease cost is the average rent expense as under current GAAP. Both models require operating leases to be capitalized as an asset and liability measured at the present value of the lease payments as newly defined. Topic 842 recognizes the substance of leases for lessees, that is, operating leases, being executory contracts, do not create a debt obligation or ownership of the leased asset as a finance/capital lease does. As a result the basic accounting and presentation principles of FAS 13/Topic 840 are retained – the ROU (right of use) asset and lease liability are separately reported and the liability is labeled an operating liability (not debt), the P&L cost is the straight line average rent. IFRS 16 treats ***all*** lessee leases as finance/capital leases (the operating lease liability ***is*** considered debt and the P&L cost is front ended).	***Commentary:*** *All lessees, both FASB and IASB, will continue to want the lowest amount capitalized as ROA, a key measure for investors and executive compensation, will deteriorate due to the addition of the new capitalized operating lease right-of-use asset. Also the capitalized lease liability will negatively impact many financial ratios for IASB companies and some, but fewer, ratios for FASB companies. There are structuring opportunities created by the new rules definition of lease payments to be capitalized (notably that variable rents based on a rate or index will not be estimated and capitalized and ONLY the expected payment under a residual guarantee will be capitalized) that can be used by lessors to structure leases with lower capitalized lease payments and as a result reduce the value of the capitalized asset (less negative impact to ROA and other measures) and lease liability. Operating lease classification will continue to be important to FASB companies as the operating lease liability is not classified as debt (less impact to financial ratios, measures and covenants that limit debt) and the lease cost is straight line (not front loaded as for IASB companies) postponing the recognition of lease costs. Operating lease classification may continue be important to IASB companies if they need to break out the operating vs, finance lease balance sheet amounts to give information to regulators (regulatory capital relief on the new ROU asset), tax authorities, lenders or other users. IASB company CFOs will probably end up having to keep a second set of records for operating leases.*

Lessor Accounting Model

IFRS 16 does not distinguish between sales-type and direct financing leases; therefore, IFRS 16 permits recognition of selling profit on direct financing leases at lease commencement even if 3rd party involvement like residual insurance is used to achieve direct finance lease classification.	***Commentary:*** *Topic 842 conforms to Revenue Recognition guidance hence the precluding of sales treatment when there is 3rd party involvement in the lease classification. The lease with third party involvement in the classification is still classified and accounted for as a direct financing agreement so the gross profit is recognized over time as part of interest income vs. up front as a gross profit on sale. This impacts captives who must plan accordingly – there may be a motivation for captives sell leases to third party vendor lessors with participation in billing and remarketing so that a sale can be recorded while customer contact is maintained and some residual profits retained.*

Variable Lease Payments

IFRS 16 requires reassessment of variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect). Topic 842 requires rebooking for a change in variable rents only when the lease is modified.	***Commentary:*** *This represents a structuring opportunity that is to use a CPI clause to postpone recognition of costs and lower the initial ROU asset value. The lessor may offer the CPI clause while offering a reduced fixed rent in anticipation of CPI increases over the lease term. The lessor will be taking on some risk but it may help with lease classification as an operating lease. It also lowers the ROU asset booked, improving ROA and it defers recognition of rent expense as the changes in rent caused by CPI increases are accounted for on a "cash basis" and long as the lease does not have to be rebooked due to a modification.*

Sale and Leaseback Transactions

IFRS 16 does not include application guidance on whether the transfer of an asset in a sale and leaseback transaction is a sale, other than to state that if the seller-lessee has a substantive repurchase option regarding the underlying asset, then no sale has occurred. Topic 842 conforms to the Revenue Recognition standard to determine if the lessee is a principal in the sale/transfer of the asset. Topic 842 does not preclude fair market value purchase options where there are alternative assets, substantially the same as the transferred/leased asset, readily available in the marketplace.	***Commentary:*** *Lessors and lessees must carefully structure transactions that may be characterized as sales/leasebacks where there is a purchase option in the leaseback. The idea is to qualify as a sale and avoid "failed" sale/leaseback accounting where the asset remains on the lessee's books and the lease is accounted for as a loan. This applies to real estate leases (including build-to-suit synthetic leases)* ***as well as equipment leases****. The EITF 97-10 guidance has not been carried forward so one must carefully read the new rules in advance of proposing on a structure to insure the lessee is never considered the owner. The new rules are based on "control" of the asset and agent vs. principal (for the lessee) concepts vs. risks and rewards as in the current rules. Regarding equipment leases of assets to be constructed like corporate jets two strategies may be employed. First choice is to make the lease decision before ordering the plane and chose a lessor to be the owner at the start of the process so that the lease is definitely not a sale leaseback. The other choice is for the lessee to sign an agency agreement with the prospective lessor in advance clearly specifying the role of the lessee as an agent with no profit element and no risks of ownership so that the lessee is never in the chain of ownership. Lessors should review their master lease agreements that involve lessees in the funding process (some allow lessees to fund daily deliveries with a periodic lessor "clean-up" funding which would be considered a sale leaseback) to make sure they do not ever put the lessee in the chain of ownership.*

Private Companies

IFRS 16 does not have guidance specifically for private companies; however, Topic 842 permits an accounting policy election for private companies to use a risk-free rate to discount the lease liability for each lease.	***Commentary:*** *It seems logical that a private company will still use its incremental borrowing rate or an estimate thereof as it will be higher than the risk free rate resulting a lower measured value for both the ROU asset and lease liability. Lessors should advise their customers of this issue. For lessees having difficulty determining their incremental borrowing rate, one approach is for the lessee to swap its floating revolver rate to a fixed rate that matches the lease term as a proxy for their incremental borrowing rate.*

Conclusion

There are other issues where there are differences in the sets of rules, such as statement of cash flows presentation, disclosures, transition and impairment as examples, which do not have business implications for lessors in structuring leases to meet customer needs. In any case lessors should understand the rules changes in detail so that they understand changed lessee business concerns and how they should or may adjust their product offerings. The news rules create some landmines but there are also some opportunities for structuring in the rules. New Rules = New Ideas!

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 50 years' experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee from 1988 to 2017and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He can be reached at wbleasing101@aol.com.