

LESSEE ACCOUNTING: DIFFERENCES BETWEEN IFRS & US GAAP

Accounting differences between IFRS and US GAAP can affect intercompany comparisons of financial leverage. The accounting treatment of debt is similar under the two regimes. Where a company plans to hold debt to maturity, it accounts for it at amortised cost. Traded debt is marked to market.

The treatment of leases differs. Both regimes now require lessees to capitalise all leases – with the exception of leases of low-value items and short-term leases. However, US GAAP classifies capitalised leases as either ‘operating’ or ‘finance’. A lease is a **finance lease** if it meets *any one* of the following five tests:

1. The lease transfers ownership to the lessee at the end of the lease term;
2. The lease contains a purchase option which is a ‘bargain’ (and thus likely to be exercised);
3. The present value of lease payments equals most (i.e. $\geq 90\%$) of the asset’s fair value;
4. The lease term covers the bulk (i.e. $\geq 75\%$) of the asset’s economic life;
5. The asset is specialised and thus has no alternative use to the lessor.¹

A lease that meets *none* of these tests is an **operating lease**. In essence, US GAAP views a finance lease as equivalent to buying an asset with debt. Any lease that is not, in substance, a debt-financed asset purchase is an operating lease. In practice, lessees applying US GAAP report most of their leases as operating leases.

What is the impact of the different classification of leases on a lessee’s accounts? The accounting is summarised in the exhibit below. The initial balance sheet impact is the same: the lessee records an asset and a liability. Differences emerge in subsequent periods. With a finance lease, the lessee depreciates the leased asset and accrues interest on the lease liability. (This is identical to the IFRS treatment of leases by lessees.) With an operating lease, it records each scheduled lease payment as lease expense (amount ‘X’ in the exhibit). It accrues interest on the lease liability each period (amount ‘Y’) but does not record it as an expense. It reduces the carrying amount of the leased asset by the difference between the lease payment and the accrued interest (amount ‘X–Y’).

LESSEE ACCOUNTING FOR LEASES UNDER US GAAP: Summary				
Lease type	Definition	Accounting treatment		
		Initially	Subsequent periods	
			Asset under lease	Lease liability
Finance lease	At least one of 5 finance lease tests is met.	Leased asset (A+)	Depn expense (E–)	(a) Interest expense (E–)
		Lease liability (L+)	Leased asset (A–)	Lease liability (L+)
				(b) Lease liability (L–) Cash (A–)
Operating lease	None of finance lease tests is met.	Leased asset (A+)	(a) Lease expense (E–) [X] (scheduled payment) Asset (A–) [X–Y]	Lease liability (L+) [Y] (accrued interest)
		Lease liability (L+)		(b) Lease liability (L–) Cash (A–)

¹ FASB, ASC 842 *Leases*, para. 10-25-2. IFRS applies the same finance lease tests – but to lessors only.

The accounting is a compromise intended to satisfy both financial statement users (who want all leases to be capitalised) and corporate managers (who dislike the front-loading of expense under finance lease accounting). Moreover, an operating lease liability is measured in the same way as a finance lease liability. The carrying amount of an operating lease liability is the present value of contractual future lease payments at the balance sheet date, discounted at the lease's effective interest rate.

Impact on financial leverage metrics

Investors must adjust income numbers when comparing the financial leverage of firms applying US GAAP with that of firms applying IFRS. Consider two income-based leverage ratios, the debt-earnings ratio and interest cover. In calculating the debt-earnings ratio, investors add back 'lease expense' relating to 'operating' leased assets to US GAAP EBITDA. In effect, EBITDA becomes EBITDAR, where R is rent (i.e. lease) expense. (The EBITDA number already excludes the depreciation and interest expense relating to IFRS-compliant leases and US GAAP-compliant *finance* leases.) The 'debt' number in the debt-earnings ratio includes all lease liabilities.

As for interest cover (EBITDA / interest expense), the numerator likewise becomes EBITDAR. In addition, the interest cost of operating lease liabilities in the year should be estimated and added to the denominator of the ratio. US GAAP does not require lessees to disclose the interest accrued on such liabilities.